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7th Annual Seminar on Securities Law

Office of Continuing Legal Education at the University of Kentucky College of Law

H. Alexander Campbell
Wyatt, Tarrant & Combs

Rutheford B. Campbell Jr.
University of Kentucky College of Law, rcampbel@uky.edu

Ivan M. Diamond
Greenebaum, Doll & McDonald

Fredrich H. Thomforde
Stone & Hinds, P.C.

See next page for additional authors

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Authors

Office of Continuing Legal Education at the University of Kentucky College of Law, H. Alexander Campbell, Rutheford B. Campbell Jr., Ivan M. Diamond, Fredrich H. Thomforde, Frederic H. Davis, Cynthia W. Young, C. Craig Bradley Jr, David W. Harper, Gary L. Stage, and Garrison R. Cox

**UK
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**7th ANNUAL
SEMINAR
ON
SECURITIES LAW**

FEBRUARY 12-13, 1988

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SEMINAR
ON
SECURITIES LAW**

FEBRUARY 12-13, 1988

**Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW**

**In Cooperation with the
KENTUCKY BAR ASSOCIATION**

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COLLEGE OF LAW
OFFICE OF CONTINUING LEGAL EDUCATION

Suite 260 Law Building
Lexington, Kentucky 40506-0048
(606) 257-2921

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PROGRAM

PROGRAM CHAIR/PROGRAM MODERATOR:

Rutheford B Campbell, Professor of Law
University of Kentucky College of Law
Lexington, Kentucky.

FRIDAY, FEBRUARY 12, 1988

- 8:00 a.m. **Late Registration**, Hyatt Regency Hotel, Lexington, KY — Coffee and Breakfast Pastries
- 8:55 a.m. **Welcome**, Todd B. Eberle, Associate Dean and Director of Continuing Legal Education, University of Kentucky College of Law.
- "Roads to Recognize, Avoid & Resolve Securities Problems"**
- 9:00 a.m. **THE DEFINITION OF A SECURITY: Current Issues and Developments**
— When a security arises in varying contexts, including oil & gas leases, syndications, and banking transactions
— Recent developments
— Projected trends
H. Alexander Campbell
Wyatt, Tarrant & Combs
Louisville, KY
- 9:50 a.m. **RESALES OF SECURITIES**
— Resales of control persons
— Resales of securities pledged to banks
— Resales of securities acquired in exempt transactions
Rutheford B Campbell
Professor of Law
University of Kentucky
Lexington, KY
- 10:40 a.m. **BREAK** — Refreshments
- 10:55 a.m. **INSIDER TRADING: The Obligation to Disclose**
— Update of recent developments under:
— Rule 10b — 5
— Section 12 (2)
Ivan M. Diamond
Greenebaum Doll & McDonald
Louisville, KY
- 11:45 a.m. **LIABILITY FOR SECURITIES LAW VIOLATIONS UNDER SECTION 12(2) OF THE SECURITIES ACT OF 1933**
— Comparisons with Rule 10b — 5
Fredrich H. Thomforde
Stone & Hinds, P.C.
Knoxville, TN
- 12:30 p.m. **LUNCHEON**, Hyatt Regency (included in registration fee)
- 2:00 p.m. **PLANNING TO AVOID OR PREVENT UNWANTED TAKEOVERS**
— Ownership and management configurations which make a corporation vulnerable
— Caselaw update
— Specific strategies to make the takeover less attractive
Frederic H. Davis
Brown, Todd & Heyburn
Louisville, KY
- 2:45 p.m. **BREAK** — Refreshments
- 2:55 p.m. **INTERVIEWING AND ADVISING THE SECURITIES CLIENT**
— Conflicts
— Engagement letter and retainer
— Due diligence — attorney
— Due diligence — client
— Initial offering checklist
Cynthia W. Young
Wyatt, Tarrant & Combs
Louisville, KY
- 3:40 p.m. **COMMON SECURITIES LAW PROBLEMS FACED BY CLOSELY HELD BUSINESSES**
C. Craig Bradley, Jr.
Stites and Harbison
Louisville, KY
- 4:30-
6:30 p.m. **Cocktail Reception**, Hosted by Pandick Press — Hyatt Regency

SATURDAY, FEBRUARY 13, 1988

8:30 a.m. Coffee and Breakfast Pastries

"Avenues to Exempt Offerings"

- 9:00 a.m. **REGULATION D — THE OFTEN UNAVAILABLE OR IMPRACTICAL SAFE HARBOR: THE SECTION 4(2) ALTERNATIVE**
— Inherent problems with Regulation D for small business financings
— Common law exemption of Section 4(2)
David W. Harper
Hirn Reed Harper & Eisinger
Louisville, KY
- 9:40 a.m. **THE INTRASTATE EXEMPTION — LOCAL BUSINESSES WITH LOCAL INVESTORS**
Gary L. Stage
Stoll, Keenon & Park
Lexington, KY
- 10:20 a.m. **STATE BLUE SKY EXEMPTIONS**
Garrison R. Cox
Odgen & Robertson
Louisville, KY
- 11:00 a.m. **BREAK — Refreshments**
- 11:15 a.m. **PANEL PRESENTATION**
— Discussion to facilitate a clearer understanding of the interrelationships between types of exempt offerings as they apply to varying client needs.
— David W. Harper
— Gary L. Stage
— Garrison R. Cox
- 12:00 noon **ADJOURN**

THE DEFINITION OF A SECURITY:

Current Issues and Developments

H. Alexander Campbell
Wyatt, Tarrant and Combs
Louisville, Kentucky

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H. Alexander Campbell

SECTION A

THE DEFINITION OF A SECURITY:

Current Issues and Developments

Prepared for the Seventh Annual Seminar on Securities Law
presented by the Office of Continuing Legal Education, Uni-
versity of Kentucky College of Law, Lexington, Kentucky,
February 12 & 13, 1988

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I. STATUTORY DEFINITIONS

"When used in this title, unless the context otherwise requires -- the term "security" means any ..."

<u>Securities Act</u> §2(1)		<u>Securities Exchange Act</u> §3(a)(10)
note		note
stock		stock
treasury stock		treasury stock
bond		bond
debenture		debenture
evidence of indebtedness	≠	
certificate of interest or participation in any profit-sharing agreement		certificate of interest or participation in any profit-sharing agreement
collateral-trust certificate		collateral-trust certificate
preorganization certificate or subscription		preorganization certificate or subscription
transferable share		transferable share
investment contract		investment contract
voting-trust certificate		voting-trust certificate
certificate of deposit for a security		certificate of deposit for a security
fractional undivided interest in oil, gas or other mineral rights	≠	[certificate of interest or participation] in any oil, gas, or other mineral royalty or lease
any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof)		any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof)

any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency

in general, any interest or instrument commonly known as a "security"

any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing

Exclusions:

None

any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency

in general, any instrument commonly known as a "security"

≠ any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing

Exclusions:

currency

note, draft, bill of exchange, or bankers acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or renewal thereof, the maturity of which is likewise limited

II. SUPREME COURT DECISIONS

A. Securities and Exchange Commission v. C.M. Joiner Leasing Corp, 320 U.S. 344, 64 S.Ct. 120, 88 L.Ed. 88 (1943).

[1] An SEC enforcement action to restrain violations of registration and anti-fraud provisions of '33 Act.

[2] The defendants marketed assignments of small tracts (perhaps averaging five acres) out of a 3,000 acre oil and gas lease (as distinguished from undivided interests in the entire lease). The offering was directed to over 1,000

prospects, of which 50 person in eighteen states became purchasers, the largest single investment being \$100. The sales literature emphasized the promoters' plan to drill on adjoining property they had retained.

- [3] The District Court in Texas and the Fifth Circuit held that the transaction involved the sale of interests in land, rather than a security or investment contract.
- [4] The Supreme Court viewed the assignment and the drilling plans as part of a package. "The exploration enterprise was woven into these leaseholds; in both an economic and a legal sense the undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung," 320 U.S. at 348.
- [5] The Court said that "the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as 'security'," 320 U.S. at 351, concluding that the instruments were within these terms.
- [6] The Court put aside the argument that the inclusion of "fractional undivided interests in oil gas, or other mineral rights" in the definition of "security" excluded the assignment of leases involved in this case, saying that this did not prevent the classification of a particular arrangement as an "investment contract."
- [7] In retrospect, the case's significance can be seen in the Court's emphasis on substance over form and on the economic/

business context in which an instrument is used.

B. Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946).

- [1] Another SEC enforcement action to restrain alleged violations of the registration provisions of the '33 Act.
- [2] The defendants marketed small tracts (averaging 1.33 acres) of land within orange groves, conveying the tracts by warranty deed. The defendants also offered service contracts for cultivation, marketing, etc. through a related entity. Most, but not all, of the purchasers of the tracts entered into service contracts, which also granted the defendants' leasehold interests and possession of the tracts.
- [3] Again, the District Court and Fifth Circuit treated the land conveyance and service contract as separate transactions, declining to couple them as a "security."
- [4] Looking to state and lower court decisions for some guidance, the Supreme Court set out the now-famous definition, 328 U.S. at 298:

"... an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."

The Court said this definition "embodies the flexible rather than a static

principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," Id.

[5] The Court held that the defendants were "offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by" defendants and the "transfer of rights in land is purely incidental," 328 U.S. at 299-300.

[6] This case remains the most frequently cited of the cases in this series. The requirement of reliance "solely" upon the efforts of others has been sometimes liberalized by a requirement that those efforts be "the undeniably significant ones." In addition, the "common enterprise" requirement can in some Circuits be satisfied with "vertical commonality" rather than the more obvious "horizontal commonality."

C. Tcherepnin v. Knight, 389 U.S. 332, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967)

[1] A private class action under the '34 Act seeking rescission of a sale of so-called "withdrawable capital shares" of an Illinois state-chartered savings and loan association, then in liquidation.

[2] The withdrawable capital shares gave the holders certain voting rights, the right to receive dividends as declared by the association's board of directors and as determined by its profits, and the power to make voluntary withdrawals subject to certain restrictions. Certain rights of assignment also applied.

[3] The Seventh Circuit concluded that the withdrawable capital shares did not amount to "securities."

[4] The Supreme Court had little difficulty fitting the shares into the definition of "security," saying that they "most closely resemble investment contracts," applying the Howey analysis, 389 U.S. at 338. However, it went on to state that the shares could also be viewed as certificates of interest or participation in any profit sharing agreement, as "transferable shares" and as "instruments commonly known as a 'security.'"

[5] In retrospect, this case, with its emphasis on the economic realities of the instruments as distinguished from an emphasis on their nature as simply "shares," no doubt contributed to the urge to apply economic analysis to all instruments that were not conventional and even to the cases where conventional instruments were used in unconventional transactions.

D. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975).

[1] An anti-fraud action under the '33 and '34 Acts by about 57 residents of an enormous (50,000 residents) housing cooperative in New York against several nonprofit sponsor corporations. The plaintiffs' essential grievance was that the monthly rental charges for the cooperative apartments were substantially higher than those represented during the pre-construction period.

[2] Typical of the cooperative form of organization, the plaintiffs were required to acquire shares of stock in the corporation corresponding to the number of rooms in the desired unit. The Supreme Court said that the "sole purpose of acquiring these shares is to enable the purchaser to occupy and apartment ...; in effect their purchase is a recoverable deposit," 421 U.S. at 842. The shares could not be transferred to a non-tenant or pledged or encumbered and would descend only to a surviving

spouse. There were no voting rights attached to the shares as such. The shares were saleable only to the sponsor or to another tenant and the sale price was limited to initial cost or initial cost plus a fraction of the mortgage principal paid during occupancy.

- [3] The Second Circuit had held that the stock in the co-op was "stock" for purposes of the statute and further held that the transaction amounted to an investment contract as defined by Howey because profits could be expected from income from commercial rentals, tax deductions allocable to interest payments, and savings as compared with nonsubsidized housing.
- [4] The Supreme Court held that it was bound to regard the stock involved as "stock" in the statutory sense, on the principle that substance should prevail over form and the emphasis should be on economic reality, citing Tcherepnin and Howey. The Court allowed that there might be "occasions when the use of a traditional name such as 'stocks' or 'bonds' will lead a purchaser justifiably to assume that the federal securities laws apply" thus making the name of the instrument relevant, especially where the "underlying transaction embodies some of the significant characteristics typically associated with the named instrument," 421 U.S. at 850-851. The Court said that the stock in question lacked "the most common feature of stock: the right to receive 'dividends contingent upon an apportionment of profits,'" 421 U.S. at 837, citing Tcherepnin. It also noted that the stock was not negotiable, could not be pledged or hypothecated, did not confer proportional voting rights, and could not appreciate in value. In rejecting the alternative "investment contract" theory, the Court acknowledged that the Howey test "embodies the essential attributes that run through all of the Court's decisions defining a security," 421 U.S. at 852. It said that the

key ingredient, the expectation of profits, referred to either capital appreciation or participation in earnings and contrasted this to cases where the purchaser was motivated by a desire to use the item purchased. The Court held that of the three forms of "profit" identified by the Third Circuit, two were irrelevant and the third, income from commercial leases, was too speculative and insubstantial.

- [5] This case follows the pattern of the earlier cases in emphasizing the economic substance of the transaction to determine whether or not a security is involved, reaffirming the fundamental principles of Howey.

E. International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers of America v. Daniel, 439 U.S. 551, 99 S.Ct. 790, 58 L.Ed.2d 808 (1979).

- [1] A private civil action alleging violation of the anti-fraud provisions of the '33 and '34 Acts by a retired union member against the union that administered the pension plan under which he claimed.
- [2] The plaintiff alleged that the pension scheme amounted to a security and that various misrepresentations and omissions constituting fraud had occurred in connection with the plan. The plan in question was compulsory in the sense that all union members were obliged to participate and noncontributory in the sense that only employers were to contribute (except, interestingly, during a break in service in which an employee could maintain eligibility by making contributions).
- [3] The District Court and Seventh Circuit held that the plan created an investment contract.
- [4] The Supreme Court, noting that pension interests were not among the types of securities enumerated in the statute,

said that "to determine whether a particular financial relationship constitutes an 'investment contract,' the test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others, citing Howey. This test is to be applied in light of "the substance -- the economic realities of the transaction -- rather than the names that may have been employed by the parties," citing Forman, 99 S.Ct. at 796.

- [5] The Court then held on the facts that there was neither an investment of money nor an expectation of profits from a common enterprise on the part of the plaintiff. As to the investment of money, the Court held that the plaintiff had not given up a specific consideration in return for a separable financial interest with the characteristics of a security, 99 S.Ct. at 796. With regard to the expectation of profits, the Court emphasized that investment earnings were a relatively small portion of the total assets of the pension funds.

F. Marine Bank v. Weaver, 455 U.S. 551, 102 S.Ct. 1220, 71 L.Ed.2d 409 (1982).

- [1] A civil action for damages under Section 10(b) of the '34 Act.
- [2] The plaintiffs bought a \$50,000 certificate of deposit from the defendant bank, then pledged it to the bank to secure the obligations of a corporation owned by two other persons. Under a guaranty agreement with the corporation, the plaintiffs were to receive a share of profits, a fixed monthly payment, the use of a barn and pasture, and the right to veto future borrowings. The corporation quickly went into bankruptcy, and the plaintiffs sought to prevent the bank from realizing under the CD, alleging misrepresentations as to the use of the loan proceeds. The plaintiffs alleged that both the CD and the guaranty

agreement were securities for purposes of the '34 Act.

[3] The Seventh Circuit agreed with the plaintiffs on both counts. It concluded that the CD was the functional equivalent of the withdrawable capital shares involved in Tcherepnin. It held the guaranty agreement to be an investment contract on the authority of Howey.

[4] The Supreme Court held that the CD was factually distinguishable from the withdrawable capital shares involved in Tcherepnin and further that a CD issued by a federally-regulated bank was not similar to other long-term debt obligations classifiable as a security by reason of federal regulatory involvement. It said that the Court of Appeals failed to give appropriate weight to the fact that the purchaser of a CD is virtually guaranteed payment in full, whereas the holder of ordinary long-term debt assumes the risk of the borrower's insolvency.

[5] As to the guaranty agreement, the Court held in substance that the agreement was not the type of instrument that comes to mind when the term "security" is used and does not fall within the "ordinary concept of a security," citing Howey and Joiner.

[6] The court's opinion is not entirely explainable in terms of its precedents.

G. Landreth Timber Co. v. Landreth, 471 U.S. 681, 105 S.Ct. 2297, 85 L.Ed.2d 692 (1985).

[1] A private civil action alleging violation of the registration provisions of the '33 Act and the anti-fraud provisions of the '34 Act and seeking rescission and damages.

[2] The plaintiff, a corporation organized for the occasion by an investment group headed by a Massachusetts attorney, purchased all of the stock of a lumber mill

business from the defendant. The defendant agreed to stay on as a consultant for a time to help the daily operations of the mill. The business eventually went into a receivership and liquidation.

[3] The District Court and the Ninth Circuit held, on the authority of Forman and Howey, that it was necessary to determine the economic realities in each case and that, on the facts of the case, the managerial control of the business had passed into the hands of the purchasers, with the result that the "reliance solely on the efforts of others" branch of the Howey test was not met.

[4] The Supreme Court held, in substance, that stock that possesses the characteristics usually associated with stock, in the form of the right to receive dividends contingent upon an apportionment of profits, negotiability, the ability to be pledged or hypothecated, the right to vote, and the capacity to appreciate in value, would be held to be "stock" for purposes of the statutory definitions. Contrasting the facts and holding in Forman, the Court said that in this case it is more likely that an investor would believe he was protected by the federal securities laws.

[5] While considering this sufficient for its decision, the Court went on to review most of its prior holdings. It said that the prior decisions that analyzed the economic substance of transactions involved unusual instruments not easily characterized as securities. No such analysis is required when an instrument is labeled "stock" and possesses all of the traditional characteristics of stock. See 105 S.Ct. at 2304. Perhaps responding to concern that such literal treatment of the meaning of stock would lead to similar treatment of notes, bonds, and other instruments that fall literally within the statutory definitions but have been excluded from the

Act's coverage by interpretation, the Court said that instruments that bear both the name and all of the usual characteristics of stock "seem to us to be the clearest case for coverage by the plain language of the definition," 105 S.Ct. 2306. To apply Howey would make the enumeration of securities in the statutory definition superflous. It expressly left for another day the question of whether notes or bonds or some other category of instrument listed in the definition were or were not to be deemed securities.

H. Gould v. Ruefenacht, 471 U.S. 701, 105 S.Ct. 2308, 85 L.Ed.2d 708 (1985).

- [1] Another private civil action alleging violation of the registration provisions of the '33 Act and the anti-fraud provisions of the '33 and '34 Acts and seeking damages.
- [2] Plaintiff purchased 50% of the stock of a corporation. After paying a portion of the purchase price, he began to doubt the accuracy of the representations made to him.
- [3] The District Court, applying the sale of business doctrine, dismissed the action. The Third Circuit reversed, deciding that the doctrine need not be applied in every case.
- [4] The Supreme Court upheld the Third Circuit on the authority of Landreth. The Court rejected the sale-of-business doctrine as a rule of decision in cases involving the sale of traditional stock in a closely-held corporation. It observed that the sale-of-business doctrine depends primarily in each case on whether control has passed to the purchaser. In many cases, this determination will be a difficult and extended factual interpretation, leading to uncertainty at the time of the transaction as to whether or not the Acts would apply.

III. SELECTED ISSUES: NOTES, PARTNERSHIPS, FRACTIONAL UNDIVIDED INTERESTS, ETC.

A. Notes.

- [1] Not all notes are "notes" or "evidences of indebtedness" in the statutory sense.
- [2] Effect of introductory clause to both statutory definitions: "... unless the context otherwise requires...." Cf. the substance-over-form approach in Forman.
- [3] Attempted distinctions: "commercial" v. "investment" notes (McClure v. First National Bank, 492 F.2d 490 (5th Cir. 974), cert. denied 420 U.S. 930 (1975)); loans of "risk capital" or not (Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 976)).
- [4] The Second Circuit's laundry list: Exchange National Bank v. Touche Ross, 544 F.2d 1126 (1976), expanded by Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930 (2d Cir. 1984) cert. denied 469 U.S. 884 (1984).

B. General partnership interests.

- [1] Such interests are apparently (sub silentio) not "certificates of interest or participation in any profit-sharing agreement" in the statutory sense. Why not is unclear (Goodwin v. Elkins & Co., 730 F.2d 99 (3d Cir. 1984)).
- [2] Investment contract analysis in terms of Howey and interplay with Uniform Partnership Act -- can a partner's profits ever depend solely upon the efforts of others?
- [3] Possible outer limits derived from Howey: a "partnership" in form but not in fact or a "partner" in name but not in fact? in fact? Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981), cert. denied 454 U.S. 897 (1981); SEC v. Professional Associates, 731 F.2d 349 (6th Cir. 1984).

[4] What impact of Landreth?

C. Limited partnerships interests.

[1] Again, such interests are apparently not viewed as "certificates of interest or participation in any profit-sharing agreement."

[2] However, investment contract analysis, coupled with Uniform Limited Partnership Act, are seen to compel conclusion that interest is a security.

[3] Possible outer limits: limited partnerships or limited partners that are not so in fact (Bank of America v. Hotel Rittenhouse Associates, 595 F. Supp. 800 (E.D. Pa. 1984)).

D. Fractional undivided interests.

[1] Nearly uniformly classified as securities under both statutory definition and by Howey investment contract analysis.

[2] Either approach may sweep in arrangements such as farm-outs that should probably be excluded from regulation. Investment contract approach might at least exclude assignments of 100% of the working interest and various transactions among joint operators.

[3] After Landreth, will alternative of using investment contract analysis be available?

E. Condominium Units.

[1] When do add-ons to the package create a Howey problem?

[2] Guidelines in SEC Release No. 5347 (January 4, 1973)

[3] Secondary consequences -- broker-dealer registration, advertising restrictions, credit restrictions

F. Investment Contract Elements.

- [1] Investment -- can a payment not be an investment?
- [2] Common enterprise -- horizontal v. vertical commonality; risk of the enterprise.
- [3] Expectation of profits -- through the efforts of the promoter only? Of others than the promoter? Soley through such efforts?

IV. SURVEY OF DECISIONS IN 1986 and 1987

The following capsule descriptions were abstracted from case digests in Securities Regulation and Law Report (Bureau of National Affairs) and include substantially all the "definition of securities" cases digested in 1986 and 1987. Citations are to volume/page number in Securities Regulation and Law Report.

A. 1986 Decisions

- [1] Undivided interests in a coal mining operation were securities, citing Landreth and Gould, because they are specifically enumerated in the definition of the term and because there was nothing about these that made them unusual or substantially different from interests traditionally considered as fractional undivided working interests. The court rejected reliance upon the lower court's Howey economic reality test and emphasis upon controls retained by investors. Penturclli v. Spector, (3rd Cir. 1985) (18/35)
- [2] Interests in an employer's profit sharing plan were not securities because they do not constitute an investment on the part of the employees, citing Daniel and Howey, but voting trust certificates held by the employee under a stock bonus plan are securities within the plain language of the definition, apparently relying upon Landreth. Foltz v. U.S

News and World Report, (D.D.C. 1986)
(18/96).

- [3] Lease of master recordings to investors, associated with transfer of investment tax credits and other features, amounted to a security, citing Howey and finding horizontal commonality as required by the Sixth Circuit in that the tax advantages to any investor were dependent upon the participation of other investors and finding dependence upon the efforts of others for "profits" in the form of the tax benefits afforded. Kolibash v. Sagittarius Recording Co., (S.D. Ohio 1986) (18/349).
- [4] Oil and gas limited partnership interests were securities, citing Howey, despite plaintiff's contention that limited partners did not relinquish all authority so that profits were not expected solely through the efforts of others. Similarly, leasing ventures involving video games, heavy equipment leases, and a secondary oil recovery project were dependent upon the efforts of the promoter. U.S. v. Morse, (9th Cir. 1986) (18/523).
- [5] Limited partnership interest was a security, even when coupled with put and call purchase options covering the interests of the general partners, citing Howey, the court finding that the power to assume control was not equivalent to the possession of control for purposes of the third prong of the Howey test. Rodeo v. Gillman, (7th Cir. 1986) (18/550).
- [6] One hundred percent participation in a loan from a bank to a customer sold to another bank was not a security, citing Howey and finding that there was no prospect of capital appreciation or profits from increased earnings or reliance upon the entrepreneurial or managerial efforts of others. Union National Bank of Little Rock v. Farmers Bank, (8th Cir. 1986) (18/587).

- [7] Common stock in marketing company jointly organized with defendant was a security, citing Landreth and withdrawing prior opinion that Howey controlled and its tests were not met. Jaybend, Inc. v. Four-Phase Systems, Inc., (W.D. Wash. 1986) (18/593).
- [8] Discretionary brokerage accounts were not securities, citing Howey, and finding that the accounts did not meet the common enterprise requirement through either horizontal or vertical commonality. Shotto v. Laub, (D.C. Md. 1986) (18/861).
- [9] CD issued by Mexican bank to Ohio resident (prior to adoption of adverse currency regulations) was security under Ohio definition that includes evidences of indebtedness and any instrument evidencing a promise or an agreement to pay money. Riedel v. Bancan, (6th Cir. 1986) (18/970).
- [10] Partnership interests of non-managing general partners were not securities, citing Williamson and Professional Associates (cited in Section III.B.[3] above), where plaintiffs had a "great deal" of control under the partnership agreement and exercised their partnership rights and powers. Matek v. Murat, (C.D. Cal. 1986) (18/1053).
- [11] Loan participations sold by Penn Square Bank to another bank were not securities where the participation had more commercial than investment characteristics. Citizens State Bank v. Federal Deposit Insurance Corporation, (W.D. Okla. 1986) (18/1100).
- [12] Thirty day loans from individuals to another individual may be securities for purposes of motion to dismiss '34 Act claims where the facts were insufficient to determine whether the transactions were commercial in nature or were the type of investment that would be covered despite the '34 Act exemption for notes

- having maturity of less than nine months. Zahra v. Charles, (E.D. Mich. 1986) (18/1162).
- [13] Loans brokered by mortgage company to investors were securities under Washington law, citing Howey and holding that broker's role in transaction was significant enough for purposes of meeting the "dependence upon the efforts of third parties" test. Washington v. Phillips, (Wash. Ct. App. 1986) (18/1366).
- [14] Bank loan to purchase boxcars in tax shelter was not security, the court holding that the bank did not acquire the note as an investment nor did it risk capital beyond the risk inherent in many commercial loans. South Carolina National Bank v. Darmstadter, (4th Cir. 1986) (18/1405).
- [15] Cattle sold in combination with feeding program were securities, citing Howey and concluding that the economic reality of the situation was that the investors did not have any real control over the maintenance of their investment. Waterman v. Alta Verde Industries, (E.D.N.C. 1986) (18/1480).
- [16] Commodity account is not a security, citing Marine Bank and finding that protection under Commodities Exchange Act was analogous to federal banking laws referred to in Marine Bank. Burton v. Heinhold Commodities, Inc., (E.D. Va. 1986) (18/1589).
- [17] Unissued shares of stock are securities for purposes of the '34 Act claim, citing Landreth and rejecting economic realities approach of Howey and Marine Bank. Sulkow v. Cross Town Apparel, Inc., (2d Cir. 1986) (18/1811).
- [18] Partnership interest was not security, citing Howey and finding that investor was sufficiently active in the partnership's management so that it could not be found that the efforts of others were

the undeniably significant ones, those essential managerial efforts that affect the failure or success of the enterprise. Stone v. Millstein, (9th Cir. 1986) (18/1860).

B. 1987 Decisions

- [1] An apparently typical construction loan participation agreement sold by an S&L service company to an S&L was not a security but simply a commercial loan, citing Howey and Forman as authorizing examination of "economic reality" because instrument did not fall plainly within the statutory definition of a security. Financial Federal Savings and Loan Association v. Savings Investment Service Corp., (W.D. Okla. 1986) (19/58).
- [2] Mortgage loan package sold by broker dealer affiliate to S&L was not a security under Arkansas securities law, citing Howey as closely paralleling Arkansas test. S&L's decision was not an investment but a commercial loan and its expected return was not dependent upon the entrepreneurial or managerial efforts of others. First Financial Federal Savings & Loan Association v. E.F. Hutton Mortgage Corp., (W.D. Ark. 1987) (19/304).
- [3] Fifteen year senior unsecured notes from manufacturer to insurance company were not securities, citing "unless the context otherwise requires" preface to Section 3(a)(10) of the '34 Act and Exchange National Bank and Chemical Bank decisions cited at Section III.A[4] of this outline, the transaction bearing a "strong family resemblance to notes evidencing loans by commercial banks for current operations" as emphasized in the Chemical Bank opinion. Equitable Life Assurance Society of the U.S. v. Arthur Andersen & Co., (S.D.N.Y. 1987) (19/440).

- [4] Condominium units sold by developer to residents were not securities for purposes of RICO predicate acts, citing Howey and progeny, in that case did not "seem to involve the sort of managerial control over an investment contemplated by the Supreme Court decisions" and citing SEC Release No. 33-5347 on the same issue. Dunbarton Condominium Association v. 3120 R Street Associates, (D.D.C. 1987) (19/445).
- [5] Interests in real estate sold in transactions between social friends were not securities, citing Howey and concluding that, although plaintiffs invested money and were led to expect profits solely from the efforts of others, the investment was not in a common enterprise. There was no horizontal commonality and no vertical commonality in the form of interdependence of both profits and losses because plaintiffs alleged that their arrangement precluded any losses. Kaplan v. Shapiro, (S.D.N.Y. 1987) (19/449).
- [6] Master video tape sold in conjunction with distribution agreement might not be security under Arizona law, citing Howey as appropriate test and reversing summary judgment for plaintiff. Factual development required to determine whether there was either horizontal or vertical commonality and whether plaintiff's expectation of profits was dependent solely on the efforts of others. Vairo v. Clayden, (Ariz. Ct. App. 1987) (19/487).
- [7] Producing oil wells and nonproducing well sites sold by owner of remaining wells in field and coupled with operating agreements were not securities, citing Howey, where purchasers possessed "significant managerial powers" such that it could not be concluded that efforts by other persons were the undeniably significant ones, the essential managerial efforts which affect the failure or success of the enterprise.

Deutsch Energy Co. v. Mazor, (9th Cir. 1987) (19/586).

- [8] Franchise agreement for beauty products was not a security, citing Howey, and emphasizing that efforts made by those other than the investors were not the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise. Meyer v. Dans un Jardin, (10th Cir. 1987) (19/588).
- [9] Gas liquification equipment and installation and maintenance agreement were security, citing Howey, and finding vertical commonality where the promoter's and purchaser's fortunes are "forever linked" by profit sharing through division of gross profit. In re Gas Reclamation, Inc. Securities Litigation (S.D.N.Y. 1987) (19/631).
- [10] Stock sold by hardware cooperative buying association to retailers as an incident of membership was not security, based upon argument following Forman (Hardware Wholesalers, Inc., Division of Market Regulation No Action Letter, Available 12/21/86) (19/842).
- [11] CD's issued by private banking corporation to individuals should be considered securities according to SEC brief citing Exchange National Bank (cited in Section III.A[4] of this outline) and distinguishing insured CD's involved in Marine Bank. Because CD's should be held to be notes, Howey investment contract principles should not be applied, citing Landreth. SEC Brief in Sanderson v. Roethenmund (S.D.N.Y. 1987) (19/859).
- [12] Loans to prospective employer were not securities, citing Howey, where plaintiff's efforts for the enterprise were to be at least as significant and essential as the efforts of others. Johnson v. Computer Technology Services, Inc. (D.D.C. 1987) (19/1057).

- [13] Debt instruments of three issuers, one an apparently state regulated trust company, should be deemed securities, according to SEC argument. State regulatory scheme was not sufficient to bring debt within the Marine Bank exception by virtue of any state regulation. SEC Brief in Holloway v. Peat, Marwick, Mitchell & Co., (10th Cir. 1987) (19/1091).
- [14] Ice machines sold with management agreement were securities, citing Howey, where any control that the investors retain under the management agreement was too insubstantial to disqualify the agreement as security. Albanase v. Florida National Bank of Orlando, (11th Cir. 1987) (19/1194).
- [15] Yacht sold with management agreement for charter and maintenance was not a security, citing Howey, and finding no common enterprise within scope of Sixth Circuit interpretation requiring horizontal commonality that ties the fortune of each investor in a pool of investors to the success of the overall venture, absent a pooling of profits or proration of losses under the management agreement. Deckebach v. La Vida Charters, (S.D. Ohio 1987) (19/1362).
- [16] Mortgage loans sold by bank to S&L were not securities, citing Sixth Circuit adoption of "risk capital" approach to classifying notes as investments or commercial loans and also citing Howey and finding that purchaser was to take an active role as a mortgage lender. Home Guaranty Insurance Corp. v. Third Financial Services, Inc., (M.D. Tenn. 1987) (19/1395).
- [17] Gold sales and refining contracts were not securities, citing Howey and the California "risk capital" test. There was no investment contract because there was neither horizontal nor vertical commonality and the investors' profits did not depend on the managerial skill or efforts of the promoter. The "risk

capital" test was not satisfied, absent a showing that the proceeds of sale of the commodity were to be applied to the capital of the promoter's business. Moreland v. California Department of Corporations (Cal. Ct. App. 1987) (19/1407).

- [18] Precious metals sold in conjunction with safekeeping and buy-back program were securities, citing Howey and finding both horizontal and vertical commonality, at least for purposes of denial of defendant's motion to dismiss. Connors v. Lexington Insurance Co., (E.D.N.Y. 1987) (19/1448).
- [19] Condominium units sold with collateral agreements guaranteeing minimum rental receipts, rebates from future sales, and other arrangements were securities, citing SEC Release No. 33-5347. Hodges v. H.R. Investments, Ltd., (N.D. Miss. 1987) (19/1454).
- [20] Voting trust certificates sold to an employee were securities under Illinois law, citing Landreth for the principle that, because voting trust certificates expressly fall within the definition of a security, the Howey economic reality test urged by the defendants was not applicable. Disher v. Fulgoni, (Ill. App. Ct. 1987) (19/1462).

RESALES OF SECURITIES

Rutheford B Campbell, Jr.
Professor of Law
University of Kentucky College of Law
Lexington, Kentucky

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SECTION B



RESALES OF SECURITIES

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RESALES OF SECURITIES

Rutheford B Campbell, Jr.

Professor of Law

University of Kentucky

Lexington, Kentucky

I. Resales of Restricted Securities (i.e., Securities Acquired Pursuant to the Exemptions Provided by Section 4(2) and Regulation D.¹

A. Generally.

1. Securities purchased under Regulation D are restricted as to resale, having the "status of securities acquired in a transaction under Section 4(2)" 17 C.F.R. Section 230.502(d). Securities purchases under Section 4(2) or Regulation D are hereinafter referred to as "restricted securities".

2. There are three ways that investors may practically resell these restricted securities (persons purchasing securities pursuant to Section 4(2) or Regulation D are hereinafter sometimes referred to as "holders").

a. Holders may resell in private transactions pursuant to the "Section 4(1 1/2)" exemption.

b. Holders may publicly resell pursuant to Section 4(1).

c. Holders may resell pursuant to Rule 144.

1. Section I of this outline draws heavily on my article, Campbell, The Plight of Small Issuers (and Others) Under Regulation D, 74 Ky L.J. 127 (1985-86). I have taken the liberty of quoting from the article without the use of quotation marks.

B. Resales Under "Section 4(1 1/2)".

1. Under this exemption, securities must be sold in transactions not involving any public offering. Thus, the issuer's original private placement exemption pursuant to Section 4(2) or Regulation D is maintained, since all of the sales and resales meet the requirements of Section 4(2). The holder's resale is exempt under Section 4(1), since it involves a "transaction by any person other than an issuer, underwriter or dealer." The holder is not an "underwriter" since a private resale does not involve any "distribution". See, e.g., Wheat Report SEC Disclosure Group, Securities and Exchange Commission, Disclosure to Investors -- A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts (hereinafter cited as "Wheat Report"), p. 161-62 (CCH (1969)).

2. Such resales must meet the same criteria applied to sales by an issuer under Section 4(2). Thus, such resales should be made only to sophisticated purchasers, and each purchaser must be supplied with or have access to the same information about the issuer that would be contained in a registration statement. For the requirements of Section 4(2), see, e.g., Schwartz, Private Offering Exemption: Recent Developments, 37 Ohio St L. J. 1, 17 (1976). For discussions of the requirements of the Section 4(1 1/2) exemption, see D. Goldwasser, The Practitioner's Comprehensive Guide to Rule 144 (1975); The Section "4(1 1/2)" Phenomenon, Private Resales of "Restricted Securities" (hereinafter cited as "Section 4(1 1/2) Phenomenon"), 34 Bus. Law. 1961 (1979).

a. These requirements often make it difficult to rely on the Section 4(1 1/2) exemption.

b. Most onerous is the disclosure requirement. Although if the original offering were recently made with a complete offering circular, disclosure may be easy and cheap, in other instances disclosure may be impossible or prohibitively expensive. Examples of this are instances in which the offering circular has become dated or the original offering was made without a complete offering circular. These problems are especially likely in the case of resales of restricted securities of small issuers.

C. Public Resales of Restricted Securities Outside Rule 144.

1. Section 4(1) of the 1933 Act provides an exemption from registration for offers and sales by persons other than issuers, underwriters or dealers. Public resales of restricted securities may be made under this exemption provided the holder is not an issuer, underwriter or dealer. See generally, 1 L. Loss, Securities Regulation 665-73 (2d ed. 1961); Volk & Schneider, The Sale of Restricted Securities Outside of Rule 144, Eighth Annual Institute of Securities Regulation 135-48 (1977); Wheat Report, at 160-77.

2. To avoid inclusion in the definition of "underwriter," which is the key issue in such resales, the holder selling in a public transaction must establish that he has a proper "investment intent" at the time he purchased the restricted securities.

3. Such an investment intent removes the holder from the definition of "underwriter", since it means that the holder did not purchase his securities from the issuer "with a view to

distribution." As a corollary, such a resale by a holder that purchased with an investment intent will not destroy the issuer's original Section 4(2) exemption, since the original private placement is considered complete when the restricted securities come to rest in the hands of a holder who possesses an investment intent. See generally, 1 L. Loss, Securities Regulation 665-73 (2d ed. 1961); Volk & Schneider, The Sale of Restricted Securities Outside of Rule 144, Eighth Annual Institute of Securities Regulation 135-48 (1977); Wheat Report, at 160-77.

4. The most important factor in establishing investment intent is the period of time between the holder's original purchase and his resale. The longer that period, the easier it is to conclude that the subsequent public resale is not inconsistent with the holder's initial investment intent. Section 4(1 1/2) Phenomenon, supra, at 1972. The "change in circumstances" doctrine may also be relevant in this regard. The doctrine provides that a subsequent public resale can be reconciled with an initial investment intent by a change in the holder's circumstances that cause the holder to change his original investment intent. See generally T. Hazen, The Law of Securities Regulation 146-47.

5. There may be some trade-off between the holding period and the change in circumstances. Thus, for example, the longer the holding period, the less dramatic the required change in circumstances. On the other hand, if the holding period is short, a more significant change is required. D. Goldwasser, supra, at 374-75.

6. Notwithstanding certain in terrorem pronouncements by the Commission, see Securities Act Release No. 5223 (Jan 11, 1972)

[1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) Paragraph 78,487, at 81,050, there is case law (United States v. Sherwood, 175 F. Supp. 480 (S.D.N.Y. 1959) (two year holding period was sufficient for resale); Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), cert. denied, 371 U.S. 896 (1959) (ten month holding period found insufficient), commentator (Campbell, The Plight of Small Issuers (and Others) Under Regulation D, 74 Ky. L. J. 127, 151-56 (1985-86)) and even Commission (see Sommer, Considerations Leading to the Adoption of Rule 144, 67 Nw. U.L. Rev. 65, 69 (Supp. 1972); D Goldwasser, supra, at Section 12.02; Section 4(1 1/2) Phenomenon, supra; T. Hazen, supra, at 145; Schneider, Acquisitions Under the Federal Securities Acts -- A Program for Reform, 116 U.Pa. L. Rev. 1323,1337 (1967-68)) support for the sufficiency of a three year holding period. In fact, some of the foregoing authorities support an even shorter holding period.

7. There is a reluctance to rely upon this common law for resales of restricted securities. See Lipton, Fogelson & Warnken, Rule 144 -- A Summary Review After Two Years, 29 Bus. Law. 1183, 1198 (1973-74).

D. Resales Under Rule 144.

1. Rule 144 was originally enacted by the Commission in 1972. Securities Act Release No. 5223 (Jan. 11, 1972) [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) Paragraph 78,487. Generally, the Rule is designed to allow limited resales of restricted securities in transactions in which information about the issuer is available and the transactions are of a type that historically have not been the most abusive.

2. As presently amended, Resales under Rule 144 may be made as follows:

a. Current public information with respect to the issuer of the restricted securities must be available. 17 C.F.R. Section 230.144(c). Generally this is met if the issuer is a reporting company under the Securities Exchange Act of 1934 (hereinafter the "1934 Act"). For non-reporting companies, the information must be "publicly available", and the meaning of that requirement is somewhat unclear. See, Campbell, *The Plight of Small Issuers Under the Securities Act of 1933*, 1977 Duke L. J. 1139, 1151.

b. The holder must have been a beneficial owner of the restricted securities for a period of two years. 17 C.F.R. Section 230.144(d).

c. There are limitations on the amount of securities that a holder may sell in any three month period. Generally, that maximum amount is the greater of 1% of the outstanding class or the average weekly trading volume for the securities. 17 C.F.R. Section 230.144(e).

d. Sales must be made only in brokers' transactions and thus without any solicitation of the buy order. 17 C.F.R. Section 230.144(f) and (g).

e. Notice of the proposed Rule 144 sale is required. 17 C.F.R. Section 230.144(h).

f. Section (k) of Rule 144 was later added and is of significance, especially to smaller issuers. Generally the section allows resales of restricted securities by non-affiliates without regard to current public information,

amount limitations, brokers' transaction requirements and filing of notice requirements. Section (k) is unavailable for sales for restricted securities by affiliates. 17 C.F.R. Section 230.144(k).

g. While Section (k) substantially eases the burden of compliance with Rule 144 for persons holding restricted securities of small issuers, still there are unfair disadvantages for for such holders. Probably the most significant of these is due to the unavailability of section (k) for resales by affiliates of the issuer. See, Campbell, The Plight of Small Issuers (and Others) Under Regulation D, 74 Ky.L.J. 127, 157-61 (1985-86).

II. Resales by Control Persons.

A. Generally.

1. Section 5 of the 1933 Act prohibits the sale of securities by "any person" unless either a registration statement is effective with regard to such securities or an exemption from the registration requirement is available with regard to such securities.

2. Section 4(1) of the 1933 Act, 15 U.S.C. Section 77d(1) (1982), however, exempts from the requirements of Section 5 "transactions by any person other than an issuer, underwriter, or dealer". Except for provisions of Section 2(11) of the 1933 Act, 15 U.S.C. Section 77b(11) (1982), Section 4(1) would exempt sales by control persons.

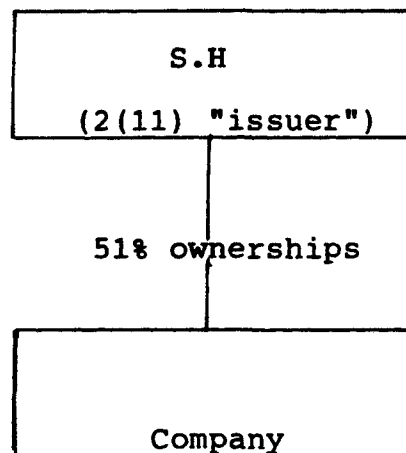
3. Section 2(11) of the 1933 Act defines "underwriter" as one who "has purchased from. . .or sells for an issuer in connection

indicates that the definition of a control person as an issuer is limited to Section 2(11) only, a control person becomes subject to the requirements of Section 5, since the exemption otherwise available through Section 4(1) is destroyed.

b. There are three configurations in which a control person gets caught under the "issuer" definition in Section 2(11).

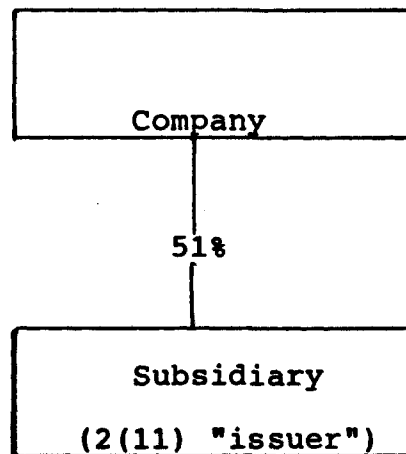
(1) A person "controlling".

This includes the situation, diagramed to the right, in which a person owns, for example, 51% of the Company. Thus, if S.H. sells stock in the Company, he may be caught by the Section 5 requirements.

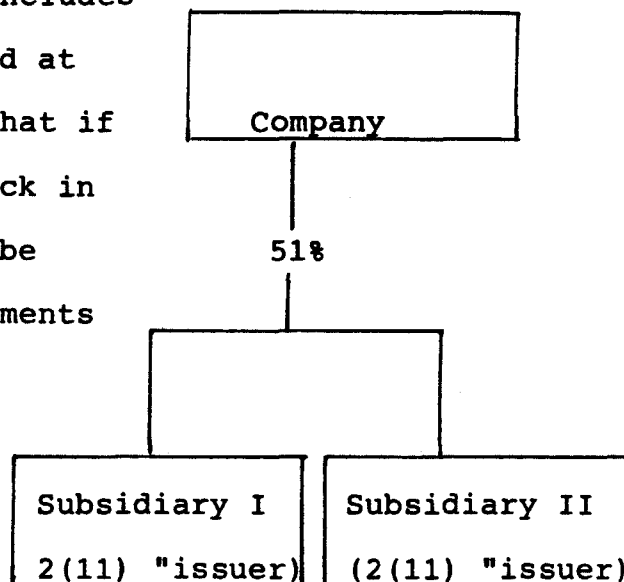


(2) A person "controlled by".

This includes the situation diagramed at the right. It means, therefore, that if the subsidiary of the Company sells securities in the Company, it may get caught by Section 5.



(3) A person "under common control with". This includes the situation diagrammed at the right. It means that if Subsidiary I sells stock in Subsidiary II, it may be subject to the requirements of Section 5.



4. It is, therefore, necessary to be able to judge the existence of "control", since only persons having some "control" relationship get caught under the foregoing analysis.

B. The Definition of "Control" Under the 1933 Act.

1. The formulation of the definition itself is unclear. There is no definition in the 1933 Act.

a. Rule 405 promulgated under the 1933 Act defines control as follows: "...the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. Section 230.405 (1984). Certain commentators have advocated this test. See, e.g., Sommer, Who's In Control?, 21 Bus. Law. 559, 582 (1966). The following are examples of courts' using this test: SEC v. American Beryllium & Oil Corp., 303 F. Supp. 912, 915 (S.D.N.Y. 1969); SEC v. Computronic Indus. Corp., 294 F. Supp. 1136, 1139 (N.D. Tex. 1968); SEC v.

Franklin Atlas Corp., 154 F. Supp. 395, 400 (S.D.N.Y. 1957).

b. Some commentators and courts have defined "control" in terms of one's ability to obtain registration. 2 L. Loss, Securities Regulation 780-81; E. McCormick, Understanding the Securities Act and the SEC 69 (1948); SEC v. International Chem. Dev. Corp., 469 F.2d 20, 28, 30-31 (10th Cir. 1972); Pennuluna & Co. v. SEC, 410 F.2d 861, 865, 866 (9th Cir. 1969); SEC v. American Beryllium & Oil Corp., 303 F. Supp. 912, 915 (S.D.N.Y. 1969); SEC v. North Am. Research & Dev. Corp., 280 F. Supp. 106, 121 (S.D.N.Y. 1968); SEC v. Micro-Moisture Controls, Inc., 148 F. Supp. 558, 562 (S.D.N.Y. 1957).

c. This writer is convinced that the "ability to obtain registration" test is a better test of control, because it is philosophically consistent with the apparent reason for requiring a control person to comply with Section 5, see H.R. Rep. No. 85, 73d Cong., 1st Sess. 13-14 (1933) (stating that an offering by a control person". . .may possess all the dangers attendant upon a new offering of securities. Wherever such a redistribution reaches significant proportions, the distributor would be in the position of controlling the issuer and thus able to furnish the information demanded by the bill"), and would be a more understandable and fairer norm. See, Campbell, Defining Control in Secondary Distributions, 18 B.C. Com. & Ind. L. Rev. 37, 38-41 (1976).

2. The cases establish three bases for control. First is the ownership of voting securities; second is a significant management position, and third is a relationship with one owning voting stock or having a significant management position.

a. The most obvious basis for control of a corporation is the ownership of voting stock. ("The power of management is ultimately . . . in the hands of the holders of voting securities." Sommer, Who's In Control?, 21 Bus. Law. 559, 567 (1977)). Although it is impossible to quantify the amount of voting control necessary to establish control, it is possible to draw certain conclusions in that regard.

(1) It is clear, for example, that ownership of 51% of the voting power of a corporation establishes control. See, e.g. SEC v. North Am. Research & Dev. Corp., 280 F. Supp. 106, where the court found control because one shareholder "owned more than 50% of the outstanding shares . . ." of a corporation. Id., at 121.

(2) It is equally clear that one with less than 51% of the voting shares of a corporation may nonetheless be classified a control person (the Commission, in In re Thompson Ross Securities Co., 6 S. E.C. 1111, 1119 (1940), stated that "[c]ontrol is not synonymous with the ownership of 51 percent of the voting stock of a corporation."), although it is impossible to draw an unwavering line defining control. Persons with 40% to 50% of voting stock were held to be control persons in United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968),

and in S.E.C. v. Micro-Moisture Controls, Inc., 167 F.Supp. 716 (S.D.N.Y. 1958), aff'd sub nom., S.E.C. v. Culpepper, 270 F.2d. 241 (2d Cir. 1959); an individual who owned 18 percent was held to be a control person in In re Thompson Ross Securities Co., 6 S.E.C. 1111 (1940); in United States v. Sherwood, 175 F.Supp. 480 (S.D.N.Y. 1959), however, the court refused to find an 8% shareholder as a control person. In each of the foregoing cases, other factors of control (or the absence of other factors of control) were relevant to the court's decision.

(3) It has been suggested that 10% ownership should be considered something of a "red light", signaling that one may be considered in danger of being a control person. Enstam & Kamen, Control and the Institutional Investor, 23 Bus. Law. 289, 315 (1968); Sommer, Who's In Control, 21 Bus. Law. 559, 56 (1966). One commentator has even suggested that 5% is the relevant figure. S.E.C. Problems of Controlling Stockholders and in Underwritings 19 (C. Israels, ed. 1962).

(4) The 10% level of ownership should be considered, at best, a crude rule of thumb regarding control. Other bases of control (discussed infra) are obviously relevant, as are factors such as the distribution of company's voting stock (a 10% shareholder is more likely to be considered a control person if his is the largest block of stock and the other 90% is widely scattered) and the actual amount of ownership involved (one with 10% ownership is, obviously, less likely to be considered a control person than is one with 40%).

See Campbell, Defining Control In Secondary Distributions,

18 B.C. Com. & Ind. L. Rev. 37, 43-44 (1976).

b. A management position with a company is a factor courts consider in determining control. In that regard, courts have emphasized positions as officers and directors as important (see, e.g., SEC v. International Chem. Dev. Corp., 469 F.2d 20, 31 (10th Cir. 1972); SEC v. National Bankers Life Ins. Co., 334 F.Supp. 444, 449, 450, 452 (N.D. Tex. 1971); SEC v. North Am. Research & Dev. Corp., 280 F.Supp. 106, 121 (S.D.N.Y. 1968); U.S. v. Sherwood, 175 F.Supp. 480, 483 (S.D.N.Y. 1959); In re Thompson Ross Sec. Co., 6 S.E.C. 1111, 1119 (1940)), as well as untitled, de facto management positions (see U.S. v. Wolfson, 405 F.2d 779 (2d Cir. 1968); SEC v. Franklin Atlas Corp. 154 F.Supp. 395 (S.D.N.Y. 1947))).

(1) Although it is difficult to generalize, most commentators and courts appear to consider a substantial management position as significant but not determinative to the matter of control. 2 L.Loss, Securities Regulation 781 (1961) ("a sort of red light"); Enstam & Kamen, Control and the Institutional Investor, 23 Bus. Law. 289, 306 (1968) ("Representation on the board has been held to be one factor which will be weighed . . ."); Wilko v. Swan, 127 F.Supp. 55, 56-58 (S.D.N.Y. 1955). There is some authority, however, indicating that a position as an officer or director is determinative of control. See, e.g., SEC v. National Bankers Life Ins. Co., 334 F.Supp. 444, 452, 458 (N.D. Tex. 1971); SEC v. Computronic Indus. Corp., 294 F.Supp. 1136, 1139 (N.D. Tex. 1968).

c. Relationships can be the basis for control. This, essentially, involves the concept of attribution. Thus for example, in certain instances Adams' control bases (e.g., either stock ownership by Adams or a management position of Adams) may be attributed to Begley. Courts seem willing to utilize such attribution concepts in instances where there is some significant relationship between Adams and Begley. See, Campbell, Defining Control in Secondary Distributions, 18 B.C. Ind. & Com. L. Rev. 37, 46-49 (1976).

(1) The relationship can be based on a contractual arrangement. Sommer, Who's In Control?, 21 Bus. Law. 559, 571 (1966); In re Thompson Ross Sec. Co., 6 S.E.C. 1111, 1121 (1940) (emphasizing that the control person "held proxies of over 50 percent of the outstanding shares").

(2) The relationship can also be based on non-contractual factors. S.E.C. v. North American Research & Development Corp., 280 F.Supp. 106 (S.D.N.Y. 1968) (business relationship); S.E.C. v. Antoine Silver Mines, Ltd., 229 F.Supp. 414 (N.D. Ill. 1968) (father-son relationship); S.E.C. v. National Bankers Life Insurance Co., 334 F.Supp. 444 (N.D. Tex. 1971) (father-in-law and son-in-law relationship).

(3) The relationship question is often characterized as a "group control" question. See, Campbell, Defining Control in Secondary Distribution, 18 B.C. Com. Ind. L. Rev. 37, 53-58 (1976). This writer would suggest that however the matter is framed, whether as a "relationship" question or a

"group" question, both the analysis and the result is the same. The ownership characteristics of one person are attributed to another if there is a significant relationship between the two or if they are both members of a group. The following court and administrative cases recognize that one may become a control person through his affiliation with a "group". U.S. v. Wolfson, 405 F.2d 779, 781-82 (2d Cir. 1968); U.S. v. Dardi, 330 F.2d 316, 325 (2d Cir. 1964); SEC v. American Beryllium & Oil Corp., 303 F.Supp. 912, 915 (S.D.N.Y. 1969); SEC v. Micro-Moisture Controls, Inc., 167 F.Supp. 716, 718, 738 (S.D.N.Y. 1958); aff'd sub nom. SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959); In re Thompson Ross Sec. Co., 6 S.E.C. 1111, 1119-20 (1940).

d. In attempting to evaluate the cases in this area, this writer previously concluded:

The cases indicate that if none of the three factors -- ownership interest, management position and personal or business relationship -- is present, a selling shareholder is unlikely to be declared a control person. If, however, one of these factors is present, there is a substantial risk that a selling shareholder will be declared a control person. The presence of two or more factors usually results in a determination that a particular individual is a control person.

Campbell, Defining Control in Secondary Distributions, 18 B.C. Com. & Ind. L. Rev. 37, 49-50 (1976).

(1) It is clear, however, that the foregoing is an overly simplistic formulation, which omits consideration of essential factors. For example, the intensity of each factor is important (one with 40% voting interest is more likely to be considered a control person than is one with a

10% voting interest; the CEO is more likely to be considered a control person than is an assistant vice-president).

b. This writer continues to rely on a touchstone: can the shareholder obtain registration. Asking this question is often helpful to evaluate whether a shareholder's control is sufficient to require compliance with Section 5 of the 1933 Act.

C. Alternatives for Sales of Securities by Control Persons.

1. One becomes an "issuer" within the meaning of Section 2(11) only if engaged in a "distribution" through an "underwriter". Otherwise, the control person has a Section 4(1) exemption available, since the control person would be neither an issuer, underwriter nor a dealer.

a. A control person selling even a limited amount of securities in a normal market transaction, therefore, would become an "issuer" within Section 2(11). The broker executing the sale on behalf of the control person would be an "underwriter" for the purposes of the transaction, and the sale on the market would be considered a "distribution", since it is, in effect, an offer of the securities to all bidders. See In the Matter of Ira Haupt & Co., 23 S.E.C. 589 (1946).

b. A control person who sells securities on its own behalf, therefore, should not be considered an "issuer" within Section 2(11), since there is no "underwriter" involved in the transaction. Accordingly, such a control person should retain an exemption from registration pursuant

to the terms of Section 4(1). I have always suspected, however, that if the offering got too large or too "public", the Commission would look hard for someone who is "selling for" the control person.

c. A control person who sells securities without becoming involved in a "distribution" should retain an exemption under Section 4(1), even if such control person engages the services on a broker-dealer or some other professional to act on his behalf.

(1) Rule 144, 17 C.F.R. Section 230.144 (1984), is one mechanism available that allows a control person to sell securities while remaining outside the definition of a "distribution". The Rule is effective for the sale of securities held by control persons in larger companies that are actively traded. It is, unfortunately, unavailable for persons holding securities in smaller companies. See Campbell, The Plight of Small Issuers (And Others) Under Regulation D, Vol. 74 Ky. L.J. (1985).

(a) Each three months, a control person can sell an amount of securities equal to the greater of 1% of the company's outstanding stock or the average weekly trading volume in the stock for the last four weeks. Rule 144(e)(1), 17 C.F.R. Section 230.144(e)(1) (1984).

(b) In addition to the foregoing volume limitations, the requirements for a Rule 144

transaction are that current public information must be available, Rule 144(c), 15 C.F.R. Section 230.144(c) (1984) (typically, this provision is met in instances where larger corporations are involved, since it is satisfied if the company has complied with the periodic reporting and proxy solicitation requirements of the Securities Exchange Act of 1934 (the "1934 Act")), that the sales be effected in "brokers' transactions", Rule 144(f) and (g), 15 C.F.R. Section 230.144(f) and (g) (1984) (typically these provisions can be met, at least within certain amount limits, so long as the stock is traded on an exchange or in the over the counter market), and that a notice of the proposed sale be filed with the Securities and Exchange Commission, Rule 144(h), 15 C.F.R. Section 230.144(h) (1984). There is a lot of literature on Rule 144, including the following books and articles: T. Hazen, The Law of Securities Regulation 152-57; D. Goldwasser, The Practitioner's Comprehensive Guide to Rule 144 (1975); Fogelson, Rule 144 -- A Summary Review, 37 Bus. Law 1519 (1981-82); Linden, Resale of Restricted and Control Securities Under Rule 144: The First Five Years, 8 Seton Hall L. Rev. 157 (1977); Lipton, Fogelson & Warnken, Rule 144 -- A Summary Review After Two Years, 29 Bus. Law. 1183 (1973-74).

(c) Rule 144 is unavailable for a control person in a small issuer, since it is impossible to meet the brokers' transaction requirements. See Campbell, The Plight of Small Issuers (And Others) Under Regulation D, Vol. 74 Ky. L.J. (1985).

(d) Sales meeting the requirements of Rule 144 do not involve "distributions", thus such sales by a control person are exempt under Section 4(1).

(2) Control persons can also utilize the so called "Section 4(1½) exemption as a basis to sell their securities.

(a) This "exemption" requires a private sale by the control person. If the control person makes a private sale of his securities (even though such control person uses the services of a paid broker or intermediary), he would not be involved in a "distribution". Because no "distribution" is involved, no "underwriter" is involved, and the selling shareholder is not considered an "issuer" under Section 2(11). As a result, the transaction should be exempt under Section 4(1) of the 1933 Act (these are called "Section 4(1½)" transactions because of the confusion as to whether the exemption is a Section 4(2) exemption (the non-public offering exemption) or the Section 4(1) exemption). For an excellent discussion of "Section 4(1½), see The Section "4(1½) "Phenomenon, Private

Resales of "Restricted Securities", 34 Bus. Law.
1961 (1979).

(b) This writer is convinced that to sell under the Section 4(1½) exemption, the selling shareholder must meet all the requirements for a Section 4(2) transaction. Generally, therefore, the following requirements must be met: (i) The purchaser must be sophisticated (i.e., must be able to evaluate the merits and risks of the particular investment); (ii) the purchaser must have access to the same type of information that would be found in a registration statement; (iii) and the selling shareholder cannot utilize any general advertising in connection with the sale.

2. The Intrastate exemption is, theoretically, available for sales of securities by a control person.

a. Unfortunately, Rule 147 is not available for sale of securities by a control person. Rule 147 (Preliminary Note 4), 17 C.F.R. Section 230.147 (Preliminary Note 4) (1984).

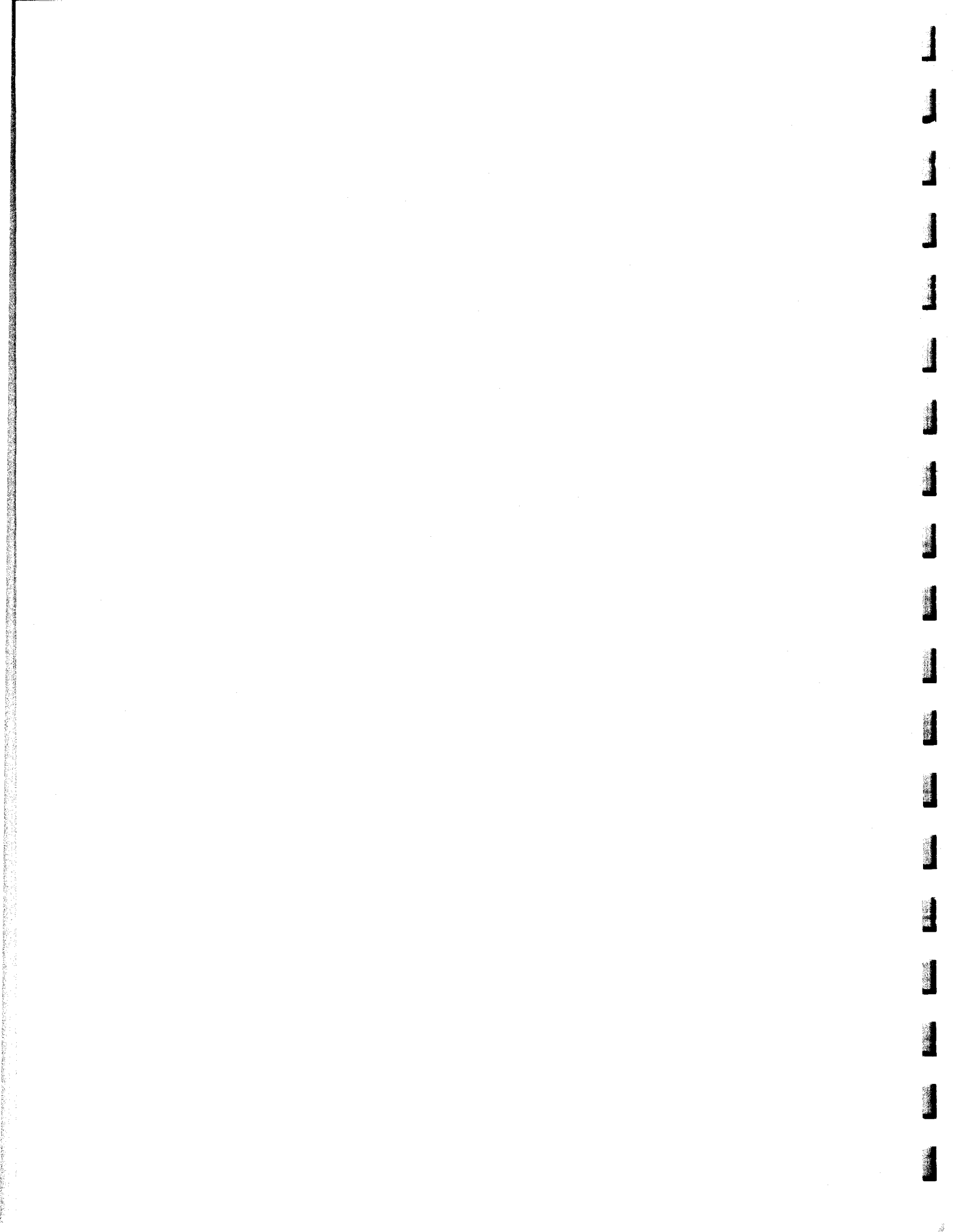
b. An offering pursuant to the common law of Section 3(a)(11) (the statutory intrastate exemption) can be made by a control person. "A secondary offering by a controlling person in the issuer's State of Incorporation may be made in reliance on section 3(a)(11) exemption provided the exemption would be available to the issuer for a primary offering in that state. It is not essential that the controlling person be a resident of the issuer's State

of incorporation." Securities Act Release No. 4434 (December 6, 1961). The restrictions and unpredictability of the common law of Section 3(a)(11), however, make it difficult and dangerous to rely on the exemption. See Kant, SEC Rule 147 -- A Further Narrowing of the Intrastate Offering Exemption, 30 Bus. Law. 73, 74-75 (1974); Gadsby, The Securities Exchange Commission and the Financing of Small Business, 14 Bus. Law. 144, 148 (1958) (that author characterized Section 3(a)(11) as "laced with dynamite").

3. Regulation D is not available for the sale of securities by a control person. Regulation D (Preliminary Note 4), 17 C.F.R. Section 230.501-.506 (Preliminary Note 4) (1984).

4. Section 4(2) of the 1933 Act, the exemption for non-public offerings (private placements), is by its terms available only to an "issuer". It is possible, however, for a control person to make non-public sales pursuant to the exemption provided by Section 4(1). See the discussion of the "Section 4(1½)" exemption, supra.

5. Section 4(6), the exemption for sales made only to accredited investors, is by its terms limited to transactions by an "issuer". 15 U.S.C. Section 77d(6) (1982).



INSIDER TRADING:
RECENT DEVELOPMENTS

Ivan M. Diamond
Greenebaum Doll and McDonald
Louisville, Kentucky

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Ivan M. Diamond

SECTION C



INSIDER TRADING: RECENT DEVELOPMENTS

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INSIDER TRADING: RECENT DEVELOPMENTS

Ivan M. Diamond, Partner
Greenebaum Doll & McDonald
Louisville, Kentucky

In general, the sanctions imposed for insider trading apply not only to trading by members of the management and employees of a publicly traded corporation on the basis of material, "inside" information, but also to trading by strangers to the corporation on the basis of material, "market" information of which the corporation may not even be aware. The Federal securities laws contain no specific provisions which make it a crime to trade in securities based on inside information. However, such prohibitions have been derived from the general anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 adopted pursuant thereto.

I. ENFORCEMENT UNDER SECTION 10(b) and Rule 10b-5.

A. In the early stages of insider trading regulation, the Securities and Exchange Commission (the "SEC") and the courts developed and applied a fairly simple rule under Section 10(b) and Rule 10b-5, known as the "Possession Theory," which provided that anyone in possession of material, nonpublic information, owed a duty to either disclose that information to persons with whom he traded, or abstain from trading or recommending the securities concerned while such information remained undisclosed.

1. The theory was applicable to both insiders and others.

2. However, inherent problems with the theory emerged, causing its eventual abandonment:

- a. The theory made no distinction between honest and dishonest information advantages;

b. The theory stifled legitimate information flow between corporate executives and securities analysts.

B. Under current law, in order to establish that trading activity is fraudulent under Section 10(b) and Rule 10b-5, one must establish the existence of each of the following elements:

- o a misrepresentation, omission (where there is a duty to speak), or other fraudulent device;
- o in connection with a purchase or sale of securities;
- o "scienter" by the defendant in misrepresenting or omitting facts;
- o materiality of the misrepresentation or omission;
- o and, for private actions, "justifiable reliance" on the fraudulent device and "damages" resulting therefrom.

1. Misrepresentation, Omission or Other Fraudulent Device. As a general rule, this element of Rule 10b-5 requires proof that a duty to disclose existed in connection with the trading of the securities in question. When such a duty exists, silence on the part of the person having material information may be fraudulent. Several theories have been developed for the establishment of this duty:

a. The Possession Theory.

b. The Fiduciary Duty Theory: A Rejection of the Possession Theory.

(i) United States v. Chiarella. ^{1/}

In Chiarella the United States Supreme Court

rejected the use of the Possession Theory for establishing a "duty of disclosure," instead holding that such a duty arises only if the defendant is an insider, a fiduciary, or a person having a relationship of trust and confidence with the other party to the transaction. The Court further held that "tippees" of information may also be liable under this "Fiduciary Duty Theory" "because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider...."^{2/}

(ii) Dirks v. SEC. ^{3/} In Dirks, the Supreme Court solidified its position with respect to the Fiduciary Duty Theory, holding that "there can be no duty to disclose where the person who has traded on inside information 'was not... a fiduciary [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'"^{4/} Moreover, the Court established the important concept of the "constructive insider," holding that persons such as underwriters, accountants, lawyers and consultants working for the corporation may become fiduciaries of its shareholders when such individuals have entered into a special confidential relationship in the conduct of the business of the corporation, and are given access to information solely for corporate purposes.

(iii) The Fiduciary Duty Theory is not

entirely sufficient for the regulation of insider trading, however, in light of its inadequacy in several situations involving "outsiders."

c. The "Misappropriation Theory" - Filling the Gaps Left By Chiarella and Dirks. Recently, several courts (lead by the Second Circuit Court of Appeals) and the SEC have adopted, and have increasingly relied upon, the so-called "Misappropriation Theory" in order to establish the "duty" element of Rule 10b-5. This theory focuses not on whether investors have been injured, but instead "on the harm that is caused to the owner of information when it is stolen or misappropriated and used in trading securities." ^{5/}

(i) Moss v. Morgan Stanley, Inc. ^{6/}

(ii) Carpenter et. al. v. United States: the "Winans" case. ^{7/} Winans represented the Supreme Court's first opportunity to consider the validity of the Misappropriation Theory:

(a) Initially, the United States District Court for the Southern District of New York found several individuals guilty of criminal securities fraud based on an application of the Misappropriation Theory. Under that doctrine, the court said, the Government was not required by Rule 10b-5 to demonstrate that the defendant had defrauded any purchaser or seller of securities. "Rather . . . a fraud perpetrated against [the defen-

dant's] employer [was] sufficient . . .'
[because the defendant] and his cohorts
defrauded [his] employer as surely as
if they took [its] money."8/

(b) The Second Circuit Court of Appeals,
in affirming the conviction, stated
that the misappropriation theory applies
broadly to "the conversion by 'insiders'
or others of material non-public infor-
mation in connection with the purchase
or sale of securities."9/

(c) The Supreme Court, however, was
evenly divided over the validity of
this theory in the securities fraud
context. It, therefore, affirmed the
Second Circuit holding without opinion.

(d) Of significance, however, was the
Supreme Court's unanimous affirmation
of Winan's mail and wire fraud convic-
tions for revealing the content and
timing of the Newspaper's "Heard on
the Street" column. This development
greatly enhanced the government's abil-
ity to prosecute criminal insider trad-
ing cases.

(iii) Criticisms of the Misappropriation
Theory:

(a) Its apparent conflict with the
Chiarella and Dirks holding that there
must be a duty to an investor before
Rule 10b-5 is violated;

(b) Its apparent failure to focus on the protection of investors and confidence in the securities markets;

(c) Its applicability only in the criminal securities fraud context.

2. In Connection With a Purchase or Sale of Securities. In addition to establishing that a "duty to disclose" existed sufficient to make silence actionable under Rule 10b-5, one must prove that such fraud was "in connection with the purchase or sale of securities," which test is met if the fraudulent activity "touches" an investor's purchase or sale of securities.^{10/}

3. Scienter by the Defendant in Misrepresenting or Omitting the Facts. One must also establish that a defendant acted with "scienter," which has been defined by the Supreme Court as an "intent to deceive, manipulate or defraud."^{11/} Moreover, several lower courts have held that a showing of mere "recklessness" may be sufficient to satisfy the scienter requirement.

4. Materiality of the Misrepresented or Omitted Fact. Finally, in order to successfully prosecute a Rule 10b-5 action for insider trading, one must establish the "materiality" of the information which the defendant failed to disclose. That is, one must establish that there is a substantial likelihood that a reasonable investor would consider the information important in making his investment decisions.^{12/}

5. Justifiable Reliance and Damages. Private litigants are required to prove, in addition to the foregoing elements, both that they justifiably relied

on the defendant's wrongful conduct in purchasing or selling securities, and that they were actually damaged as a result of such reliance, before recovery under Rule 10b-5 is available.

II. REGULATION OF TENDER OFFER INFORMATION ABUSES THROUGH RULE 14e-3.

In an attempt to further shore up the gaps left by the Chiarella and Dirks decisions, the SEC has adopted Rule 14e-3.^{13/} That rule requires a person to either disclose or abstain from trading if he is in possession of material nonpublic information relating to a tender offer when he knows or has reason to know that that information is non-public, and was acquired, directly or indirectly, from the tender offeror, the issuer of the securities in question, or any of their respective officers, agents or employees.

III. THE INSIDER TRADING SANCTIONS ACT OF 1984.

In order to curb increasing insider trading activities in the securities markets, Congress enacted, in mid-1984, the Insider Trading Sanctions Act.^{14/}

- A. Civil penalty of three-times the profits gained.
- B. Measured by trading price of security a reasonable time after public dissemination of information.
- C. Increasing the potential penalty for criminal violations.

IV. RECENT ENFORCEMENT ACTIVITIES.

- A. Dennis Levine: Disgorgement of approximately \$11.6 million in profits, permanently enjoined from future secur-

ities violations, sentenced to two years in prison and fined \$362,000.^{15/}

B. Kidder, Peabody & Co.: Disgorgement of \$13.5 million in profits, civil penalty of \$11.5 million, and permanent injunction from future violations.^{16/}

C. Ivan Boesky: Disgorgement of \$50 million in profits and civil penalty of \$50 million, all from personal assets; eventually pled guilty to conspiracy to file false Schedule 13D in connection with securities of Fischback Corp.^{17/}

D. Israel Grossman: Sentenced to two years in prison and fined \$25,000; remains the subject of an SEC civil disgorgement action.^{18/}

V. PROPOSED STATUTORY DEFINITIONS OF INSIDER TRADING.

A. "The Insider Trading Proscription Act of 1987" - Senate Bill No. 1380.

B. New York Stock Exchange Legal Advisory Report Proposed Definition.^{19/}

C. "The Insider Trading Act of 1987" - SEC Proposed Definition, Submitted August 3, 1987.

VI. DISCLOSURE PROBLEMS OF THE CORPORATE ISSUER.

A. Corporate issuers generally have no duty to disclose corporate developments, except:

1. Disclosure requirements of the SEC relating to annual, quarterly and other reports;

2. Duties of disclosure relating to an issuer's purchase or sale of its own securities;

3. Duty arising once an issuer does choose to speak (duty not to be "materially misleading").

Levinson v. Basic, Inc.^{20/}

According to the Sixth Circuit Court of Appeals, a duty to disclose under Rule 10b-5 arises when a corporation has made public statements which would be misleading absent disclosure of certain merger negotiations then under way. "If a corporation is not under a duty to disclose corporate information, but voluntarily chooses to make a statement and the statement is 'reasonably calculated to influence the investing public' the corporation then has a duty to disclose sufficient information so that the statement made is not 'false or misleading or . . . so incomplete as to mislead.'"^{21/} Oral arguments were recently heard by the Supreme Court of the United States, however, a decision has not yet been issued.

4. Duty to disclose material developments in the company's operations which have caused prior statements made by the company to become misleading.

B. Corporate issuers generally have no duty to correct or dispel rumors or statements made by other persons.

C. A corporate issuer may become exposed to liability if it has communicated material nonpublic information to others who trade on the basis of that information, unless the company also discloses such information to the public.

VII. REGULATION UNDER SECTION 12(2) OF THE SECURITIES ACT OF 1933.

Section 12(2) of the Securities Act of 1933^{22/} generally provides that where a person offers or sells a security by the use of any means of transportation or communication in interstate commerce or of the mails, and by means of a prospectus or oral communication which includes an untrue statement of material fact, or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they are made, not misleading, the person purchasing such security from him may, if he still holds the security, have such contract of sale rescinded, or if he has disposed of the security, obtain damages for any injury sustained as a result of such sale. Proof of reliance upon the truth of the statement made is unnecessary for recovery, however, a purchaser cannot recover if he knew of the untruth or omission at the time of the purchase. Further, the seller may avoid liability if he is able to sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

A. In general, liability under Section 12(2) attaches regardless of whether the security in question was sold in violation of the registration section of the Securities Act.

B. Traditionally, courts have limited liability to the plaintiff's immediate seller, whether it be the issuing company or otherwise. That is, a privity requirement is imposed upon the plaintiff.

1. Issuers may also be held responsible for violations of Section 12(2) committed by "best efforts"

underwriters selling on the company's behalf; privity being based on the agency relationship existing between the two entities.

2. Courts are split, however, over whether such privity exists in the case of "firm commitment" underwriters.

ENDNOTES

1. 445 U.S. 222 (1980).
2. Id. at 230, n. 12.
3. 463 U.S. 646 (1983).
4. Id. at 654 (quoting Chiarella, 445 U.S. at 232).
5. Report of the New York Stock Exchange Legal Advisory Committee: Proposed Statutory Definition of Insider Trading, at 10 (June 30, 1987).
6. 719 F.2d 5 (2d Cir. 1983).
7. 108 S. Ct. 316 (1987).
8. United States v. Winans, 612 F.Supp. 827 (S.D.N.Y. 1985) aff'd. in part and rev'd. in part sub. nom. United States v. Carpenter, 791 F.2d 1024 (2d Cir.) cert. granted 107 S. Ct. 666 (1986).
9. 791 F.2d 1024, 1029 (2d Cir.) cert. granted 107 S. Ct. 666 (1986) (emphasis in original).
10. Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1971).
11. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).
12. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).
13. 17 C.F.R. §240.14e-3 (1986).
14. Pub. L. No. 98-376.
15. SEC v. Dennis Levine a/k/a Mr. Diamond, 86 Civ. 3726 (S.D.N.Y. 1986); Securities Exchange Act Rel. No. 34-23300 (June 5, 1986).
16. SEC v. Kidder Peabody & Co., Inc., 87 Civ. 3869 (S.D.N.Y. June 4, 1987) Lit. Rel. No. 11452.
17. SEC v. Boesky, Civil Action No. 86-8767 (S.D.N.Y. Nov. 14, 1986).
18. See SEC v. Israel G. Grossman, et al., Civil Action No. 87-1031 (S.D.N.Y. Feb. 17, 1987).

19. Report of the New York Stock Exchange Legal Advisory Committee: Proposed Statutory Definition of Insider Trading (June 30, 1987).
20. 786 F.2d 741 (6th Cir. 1986).
21. Id. at 746.
22. Securities Act § 12(2), 15 USCS § 771(2).

LIABILITY FOR SECURITIES LAW VIOLATIONS UNDER
SECTION 12(2) OF THE SECURITIES
ACT OF 1933

FREDERICH H. THOMFORDE, JR.
KNOXVILLE, TENNESSEE

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SECTION D



LIABILITY FOR SECURITIES LAW VIOLATIONS UNDER
SECTION 12.(2) OF THE SECURITIES ACT OF 1933

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LIABILITY FOR SECURITIES LAW VIOLATIONS UNDER
SECTION 12(2) OF THE SECURITIES
ACT OF 1933

I. INTRODUCTION

A. Since the Supreme Court's opinion in *Ernst & Ernst v. Hochfelder*, and its requirement that plaintiffs demonstrate scienter, plaintiff's lawyers in securities law cases have explored other avenues in an effort to seek redress for clients allegedly defrauded in the purchase or sale of securities. In addition to state common law and statutory provisions, plaintiff's lawyers have discovered Section 12 of the Securities Act of 1933. The purpose of this outline is to provide an analysis of the elements of an action based on Section 12. We begin with a brief overview of Section 12(1) and Section 12(2) of the Act followed by a more in depth treatment of a cause of action based on the section. In addition, the outline will highlight, where relevant, the manner in which Section 12 actions are distinguished from those based on Rule 10b-5.

B. Section 12(1): An Overview

Although this outline will concentrate on Section 12(2) of the Act, we will refer from time to time to the remedies provided for in Section 12(1). Section 12(1) provides an action against any person who offers or sells a security in violation of Section 5 of the Act. An action based on Section 12(1) does not require proof of fraud; rather, the plaintiff need demonstrate only that he has purchased securities that were sold in violation of the registration provisions of Section 5. The cause of action is available for new issues of securities, including those sold pursuant to so-called private placements. In particular, if an issuer cannot sustain the burden of proving that an exemption

from registration exists, Section 12(1) provides that the purchaser can receive the return of his money, plus interest, all without proof of fraud. The remaining portions of the outline will discuss the elements of a Section 12 action in more detail. As will be seen, one of the significant hurdles for a plaintiff seeking to utilize Section 12 is the privity requirement of the Act.

C. Section 12(2): An Overview

Unlike an Action based on a Rule 10b-5, which is an implied right of action, Section 12(2) provides an express remedy for fraud in connection with the sale of a security. Further, an action based on Section 12(2) does not require proof of scienter; rather, it is a negligence provision. Contrary to some popular opinion, the section is not limited to fraud in connection with the new issue of securities. The Section is also applicable to fraud in the trading markets. However, unlike Rule 10b-5, the action is not applicable to defrauded sellers. It also exempts from coverage certain securities including bank stocks and government securities. Again, as is the case with actions based on Section 12(1), a significant problem for plaintiffs is the privity requirement of the section, which is discussed below.

II. TRANSACTIONS TO WHICH SECTION 12 IS APPLICABLE

- A. Section 12(1): Section 12(1) applies to offers as well as sales of new issues and secondary offerings that have been made in violation of the registration provisions of Section 5. Because Section 5, in effect, requires the registration of securities prior to their offer or sale unless an exemption is available, the remedies provided for in Section 12(1) are

applicable whether or not the sale of securities involves a public offering or a private placement, limited offering, or other attempted exempt transaction. It is important to note that fraud is not an element of proof in an action based on Section 12(1). Rather, the plaintiff need merely demonstrate that he purchased a security that was not registered and the burden of proof then shifts to the defendant/issuer to demonstrate that an exemption was available. If no exemption is available, the remedies provided for by the section come into play.

- B. Section 12(2): Section 12(2) is only applicable when securities are alleged to have been sold by means of fraud, as herein after defined. For purposes of Section 12(2), unlike Section 12(1), it is not important whether or not an exemption from registration existed. Consequently, even if an exemption from registration exists, if the securities were sold by means of fraud, an action under Section 12(2) is available. Further, again unlike Section 12(1), an action based on Section 12(2) is available not only for new issues of securities, but also for fraud in connection with transactions in the trading markets.

Please note the following aspects of the action based on the Section 12(2) which limits its applicability:

1. Section 12(2) specifically exempts from coverage securities that are exempted from registration pursuant to Section 3(a)(2) of the Act. In general Section 3(a)(2) exempts from coverage municipal securities and bank stock. Thus, for example, the only Federal remedy available in such cases may be an action based on Rule 10b-5.
2. Note also that, unlike an action based on a Rule 10b-5,

an action based on Section 12(2) is applicable only to defrauded purchasers; it is not available to defrauded sellers in the trading market.

3. Section 12(2) is specifically applicable to securities sold by means of fraud contained in either a prospectus or oral communication. Note, however, that the term prospectus as defined in Section 2(10) of the Act includes, in addition to the printed prospectus that we are used to seeing published in connection with a registered public offering, any "notice, circular, advertisement, letter or communication, written or by radio or television, which offers any securities for sale or confirms the sale of any securities".

III. JURISDICTION

A. Concurrent State and Federal Jurisdiction:

Pursuant to Section 22(a) of the Act, the United States District Courts "concurrent with state and territorial courts," have jurisdiction "of all suits in equity and actions at law brought to enforce any liability or duty created by this title". Thus, a plaintiff may elect whether to institute his action in State or Federal Court based on Section 12.

B. Venue:

Also pursuant to Section 22(a) of the Act, an action based on Section 12 "may be brought in the district where in the defendant is found or is inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated there in

C. No Removal:

Pursuant to Section 22(a) of the Act "no case arising under this title and brought in any State court of competent jurisdiction shall be removed to any court of the United States".

IV. USE OF JURISDICTIONAL MEANS

- A. Section 12(2) provides a technical, but protentionally significant, difference when compared with Section 10(b) of the 1934 Act in it's requirement of use of means or instrumentalities of interstate commerce. In particular, Section 12(2) requires the offer or sale of the securities to be accomplished "by the use of any means or instruments of transportation or communication in interstate commerce or of the mails". Section 10(b), on the other hand, requires "use of any means or instrumentality of interstate commerce or of the mails". Based on this vermatically distinction, some courts have concluded that an action based Section 12(2) requires that the means or instrumentalities of transportation or communication actually cross state lines because of the section's use of the words "...in interstate" commerce. See, e.g. Myzel v. Fields, 386 F.2d 718, at 727, n.2(8th Circuit, 1967).
- B. Must the fraud be communicated by means of the jurisdictional means? The answer provided by the majority of courts is that while some aspect of the transaction must utilize the jurisdictional means, it is not necessary that the written or oral misrepresentation itself be conveyed by use of means of transportation or instrumentalities in interstate commerce. See, e.g., McLean v. Boyles, 275 F.2d 431(8th Circuit, 1960). The Seventh Circuit in a 1949 opinion has been the loan dissenter. See, Kemper v. Lohnes, 173 F.2d. 44(7th Circuit 1949).

V. STATUTE OF LIMITATIONS

- A. Section 12(1): Pursuant to Section 13 of the Act, an action cannot be maintained to "enforce a liability created under Section 12(1), unless brought within one year after the violation upon it is based. In no event shall any such action be brought to enforce a liability created under ...Section 12(1) more than three years after the security was bona fide offered to the public".
- B. Section 12(2): Pursuant to Section 13 of the Act, an action brought to pursuant to Section 12(2), must be "brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence". Like Section 12(1), the statute of limitations for Section 12(2) has a three year cap. However, it is worded slightly differently: an action under Section 12(2) may not be brought "more than three years after the sale".
- C. In action brought to pursuant Rule 10b-5, because it is an implied right of action, the 1934 Act does not provide a statute of limitations. Consequently, the courts look to the comparable state statute of limitations for actions that are most comparable to a securities fraud action. Frequently, this is determined to be the private right of action provided for in the state securities acts.

VI. MISREPRESENTATION AND OMISSIONS

- A. Like Rule 10b-5, Section 12(2) applies not only to misrepresentations but also to omissions. Thus, the section encompasses written and oral communications "which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under in which they were made, not misleading". Please note, that while we ordinarily refer to the section being applicable to both to misrepresentations and omissions, the provision does not literally apply a situation of complete nondisclosure. Rather, it's applicability is to the "half truth" as a practical matter, however, there will almost always be present some other statements made in connection with the solicitation or sale of the security to provide the bases for the half truth. Indeed, in the context of a Regulation D offering, for example, the offering circular itself is among the most fruitful sources to search for an omission. Note also that, while the Act applies to misrepresentations or omissions included in a written statement, Section 12(2) applies to oral communications as well.
- B. Materiality: Like Rule 10b-5, Section 12(2) requires that the misrepresentation or omissions be "material". While differing definitions of materiality have been offered and utilized by the courts, we seem now to have settled upon the definition offered by the Supreme Court in TSC Industries. Thus, a misrepresentation or omission will be material if there is "a substantial likelihood that a reasonable investor would consider the (misrepresented or omitted fact) important". TSC Industries, Inc. v. Northway,

426 US 438(1976). This definition is something of a compromise between two extremes. On the one hand, there were those who urged a definition of materiality that would require that the misrepresented or omitted fact had a decisive effect on the investment decision. On the other hand, there was those who urged a definition that would make a fact material simply because an investor might consider the fact important. As you can see from the Supreme Court definition, it requires a substantial likelihood that a reasonable investor would (not might) coincider the fact important (not decisive).

VII. SCIENTER

- A. One of the critical factors that has caused a renewed interest in Section 12(2) was the Supreme Court's holding in Hochfelder that scienter is required in a Rule 10b-5 action. As you will see from the language of the section itself, Section 12(2) is a negligence section. Thus, it imposes liability on any person who "shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission". What constitutes reasonable care under the circumstances is a fact question that will vary from case to case. Note, however, that Section 12(2), unlike Section 11 of the 1933 Act, does not specifically require "reasonable investigation". Nevertheless, under the circumstances of a particular case, the "reasonable care" requirement of Section 12(2) may well dictate that the particular defendant engage in a "reasonable investigation" of the material facts. See e.g. Sanders v. John Nuveen and Company, 619 F.2d.1222(7th Circuit 1980), cert. denied 101 S.Ct. 1719 (1981).

B. Burden of Proof: It is clear from the section itself that, not only is it a negligence provision, but the burden of proof to establish that reasonable care was exercised is on the defendant. Given the construction of the language of Section 12(2), there can be initial confusion regarding just who (i.e. the plaintiff or the defendant) is to carry the burden of proof. A careful reading demonstrates that what the section provides is that "any person who offers or sells a securities (by means of fraud) and who (i.e. the person offering or selling) shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth omission, shall be liable to the (purchaser)".

VIII RELIANCE

- A. Although there is some confusion regarding the reliance requirement under Rule 10b-5, it is clear that, at least under some circumstances, reliance is a required element of proof in a Rule 10b-5 action. In the other hand, it is equally clear that there is no reliance requirement in a Section 12(2) action. The section only requires that the purchaser allege (and be prepared to testify) that he did not know of the untruth or omission. The courts have made it clear that this element of Section 12(2) will not be construed as a reliance requirement. See, e.g. Sanders v. John Nuveen and Company, supra.
- B. Plaintiff's Due Diligence: Not only does Section 12(2) not impose a reliance requirement on the plaintiff, but it is clear that there is no due diligence or "due care" obligation imposed on a plaintiff in a Section 12(2) action. See e.g. Sanders

v. John Nuveen and Company, supra.

C. Plaintiff's Sophistication: Because Section 12(2) is frequently used in connection with a fraudulent private placement, there is sometimes confusion regarding the relevance of plaintiff's sophistication. However, it is clear that sophistication is relevant only to determine whether the issuer has an exempt transaction pursuant to Section 4(2) of the Act or pursuant to Rule 506 of Regulation D; it has no relevance in determining whether or not the securities were sold by means of fraud. See, e.g., Sanders v. John Nuveen and Company, supra.

IX. THE PRIVACY REQUIREMENT

A. Clearly the most difficult and most litigated portion of Section 12(2) is the privity requirement. The source of the difficulty is in the language itself which literally requires privity. Thus, the section provides that the seller "shall be liable to the person purchasing such security from him". If strict privity were required, a number of potential "sellers" who were intended by Congress to be within the ambit of the section would escape liability. For example, a broker dealer acting as agent in the trading market is not literally the seller in the sense of the person who passes title. Also, for example, in a new issue of securities only the company issuing the securities is the one that technically passes title, and thus the individuals responsible for the misrepresentation or omission would escape liability. The courts have reacted to this difficulty with a number of approaches, which will be discussed below.

- B. Agent Liability: One early and perhaps obvious approach adopted by the Federal Courts was to impose liability on agents of the sellers. See, e.g., *Cady v. Murphy* 113 F.2d. 988(1st Circuit), cert. denied 311 US 705(1940). While the notion that an agent of an seller should be liable for misrepresentations that he makes in connection with the sale of securities for the seller, we shall discuss a related, but distinguishable, problem below which deals with the statutory liability of a person who controls the seller.
- C. Participant Liability: A second approach adopted by several federal circuits goes beyond the traditional notions of agent liability and expands the scope of potential "sellers" to include those who, although not technically agents of the sellers, are persons who have been a party to the solicitation, sometimes modified somewhat by requiring that the person be a "substantial participant". See, e.g., *Katz v. Amos Treat and Company*, 411 F.2d. 1046(2d. Circuit 1969). Obviously, if a person need only be a party to the solicitation or have somehow participated in the mix of activities that are necessary in order for the transaction to be consummated, the range of persons arguably exposed to liability can be somewhat frightening, particularly if it were to include persons that had no real role in the misrepresentation that was part of the solicitation.
- D. Civil Aider and Abettor: Another approach that has been discussed more than it has actually been adopted by the federal courts is the civil aider and abettor theory. Although this theory has been utilized in connection with Rule 10b-5 actions, recall that in a Rule 10b-5 action, with the scienter requirement,

for a principle defendant to be liable the plaintiff must demonstrate intent, or at least reckless disregard for the truth. In an action based on Section 12(2) on the other hand the defendant/seller will be liable based on negligence. The significance of the distinction is important since the civil aider and abettor theory ordinarily is defined as having at least two prongs: (1) the defendant (i.e. the aider and abettor) must know that securities are being sold in violation of Federal Securities Law; (2) the defendant must provide substantial assistance in the transaction. Thus, were we to apply the aider and abettor theory in the Section 12(2) context, the aider and abettor, unlike the principle defendant, would be liable only if it acted with knowledge of a violation, which would approach the higher standard imposed by Rule 10b-5. Most courts, including the Sixth Circuit, have refused to utilize the aider and abettor approach. See, e.g., *Davis v. Avco Financial Services, Inc.*, discussed infra.

- E. The Sixth Circuit: An important Sixth Circuit opinion on participant liability is *Davis v. Avco Financial Services, Inc.*, 739 F.2d 1057(6th Circuit, 1984), cert. denied (1985). In that case, the court was faced with a defendant who, among other things, had loaned money to a purchaser to finance the transaction and had made glowing representations regarding the investment. He was not, however, the actual seller nor was he an agent of the seller. The Sixth Circuit adopted a variation of the participant theory with a two prong approach; (1) first, the court applied a "but for" test to determine whether or not the defendant's conduct was a proximate cause for the transaction; and (2) was the defendant's conduct a "substantial" factor in effecting

the sale. Of significance is the fact that, for liability to be imposed under this test, the defendant need not be an agent of the seller. On the other hand, the Avco approach would not specifically require that the defendant had directly participated in the solicitation. Further, unlike the aider and abettor theory, it does not require that the defendant have actual knowledge of a violation. Rather, it would impose the "reasonable care" standard.

X. LIABILITIES OF CONTROL PERSONS

- A. Pursuant to Section 15 of the Securities Act of 1933, liability is imposed on persons who control other persons who are liable pursuant to Section 12 of the Act. The liability is joint and several. The provision is applicable to "every person who, buy or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under Section ...12".
- B. Relation of Section 15 to the Doctrine of the Respondeat Superior:
One question addressed by the courts in connection with Section 15 is whether or not Section 15 should be read as limiting or modifying the common law doctrine of the Respondeat Superior. The problem is caused in part by the nature of the defense provided by the Section for control persons. In particular, the control person will not be liable if he "had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the control person is alleged to exist".

Thus, the section provides a defense that would not ordinarily be available to a principal under the vicarious liability theory of respondeat superior. Thus circuit courts that have addressed the issue, including the Sixth Circuit, have determined that Section 15 does not supplant respondeat superior; rather, both theories are viable. At least three circuits, the Third, Eighth and Ninth, have suggested that Section 15 supplants respondeat superior. In the Sixth Circuit, the Avco case, discussed the above, in fact imposed liability on the principal under the doctrine of respondeat superior despite the fact that the principal had no actual knowledge of its agent's violations.

XI. REMEDIES

- A. Section 12 provides specific remedies. If the purchaser still holds the securities, he may recover "the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security". If the purchaser has already sold the security, he is entitled to damages. It is generally believed that damages is limited to an amount representing the difference between the original purchase price and the price at which the resale took place.
- B. Punitive Damages: It is generally held that punitive damages are not available under the securities acts. See, e.g., *Young v. Taylor*, 466 F.2d 1329,1338(10th Circuit 1972). However, under pendent jurisdiction, it is conceivable that, given the right fact situation, the plaintiff may want to allege common law deceit and thus provide the basis for punitive damages.

**Civil Liabilities Arising in Connection
With Prospectuses and
Communications**

Sec. 12. Any person who—

(1) offers or sells a security in violation of section 5, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Limitation of Actions

Sec. 13. No action shall be maintained to enforce any liability created under section 11 or section 12(2) unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 12(1), unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section 11 or section 12(1) more than three years after the security was bona fide offered to the public, or under section 12(2) more than three years after the sale.

Contrary Stipulations Void

Sec. 14. Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void.

Liability of Controlling Persons

Sec. 15. Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

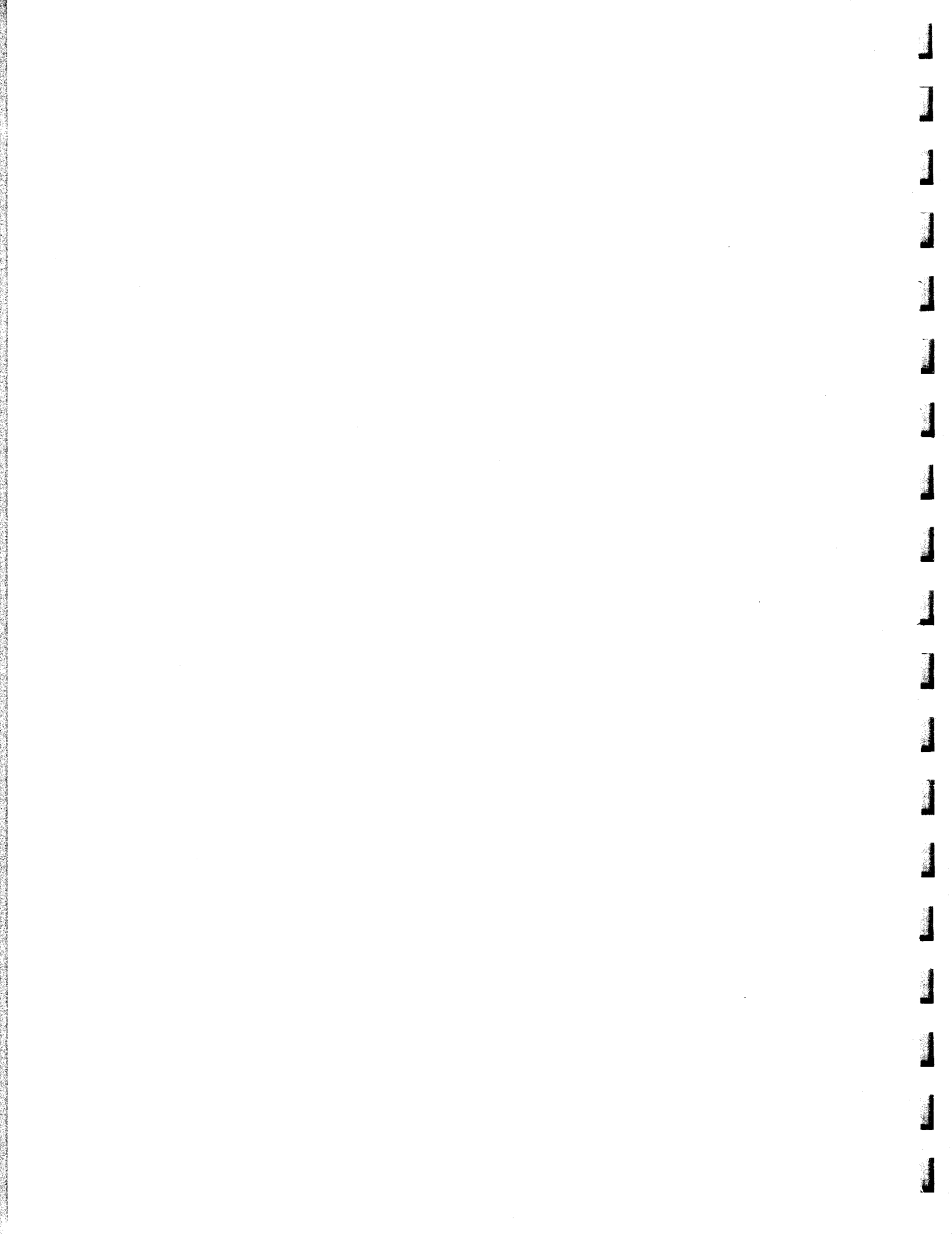
PLANNING TO AVOID OR PREVENT
UNWANTED TAKEOVERS

Jay Middleton Tannon

Marsha T. Dula
and
Cynthia L. Stewart
Brown, Todd and Heyburn
Louisville and Lexington, Kentucky

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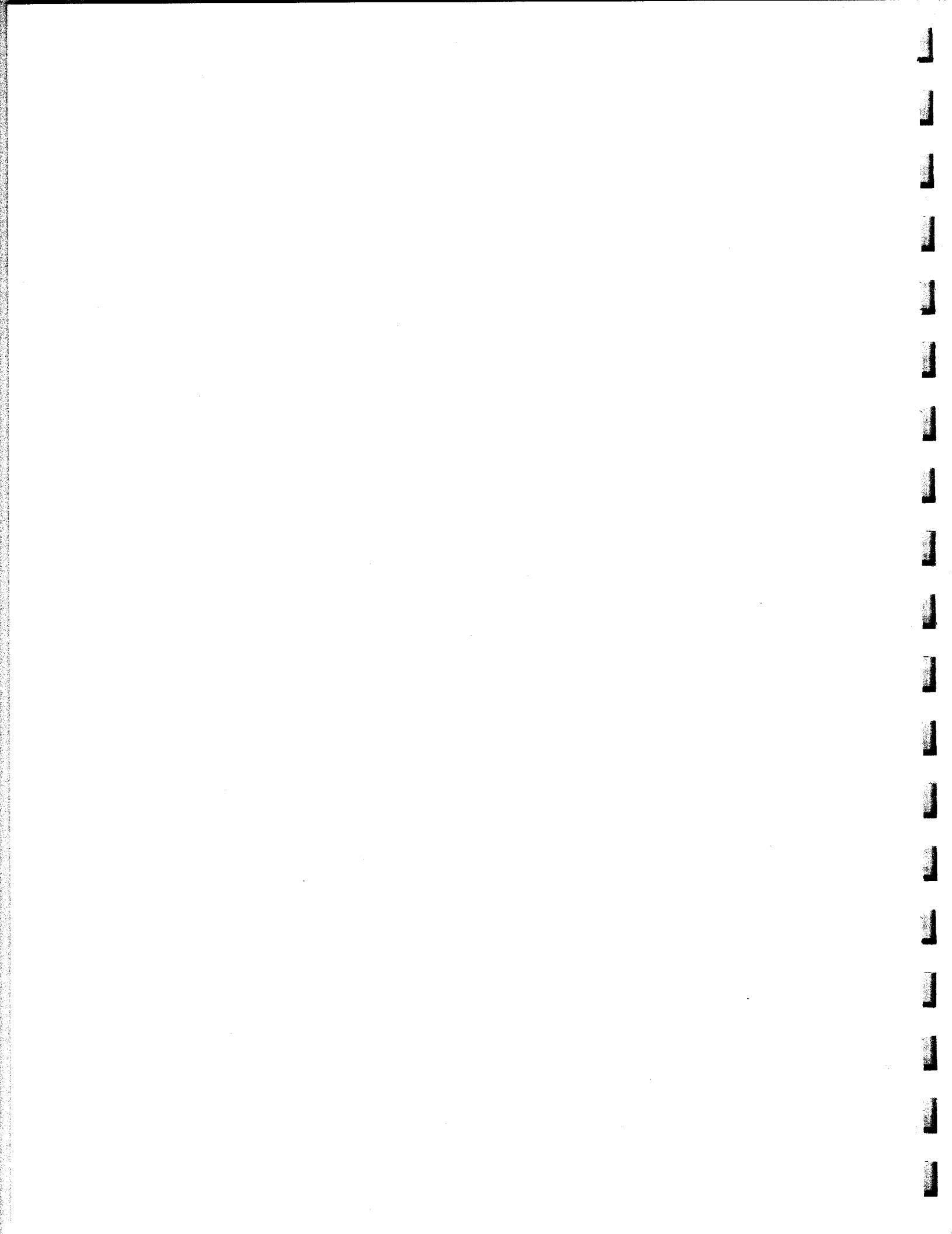
SECTION E



PLANNING TO AVOID OR PREVENT
UNWANTED TAKEOVERS

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I. ANTI-TAKEOVER TACTICS AND STRATEGIES - ADVANCE PLANNING

A. Article and Bylaw Amendments

1. Introduction. In the wake of increasing takeover activity, many Kentucky companies, whether publicly or closely held, have recently amended their respective articles of incorporation, bylaws or both. Typically, these amendments help assure continuity of management by making it more difficult to replace directors during a takeover fight. The amendments also frequently seek to protect "minority" shareholders in the event a bidder establishes a significant position in the target and subsequently seeks to acquire the remaining stock at a bargain price. Such provisions most commonly take the form of supermajority vote or "fair price" requirements.

Reasons for adopting such protective provisions abound. First, while the efficacy of these "shark repellent" measures is subject to debate, one may assume that, all other things being equal, a prospective bidder will more likely pursue a company which has failed to adopt shark repellents than a company which has taken anticipatory defensive action. In addition, proposal and adoption of antitakeover measures indicates shareholder support for aggressive management action against unfriendly suitors. Third, the operation of these provisions may in fact frustrate a bidder who has accumulated a meaningful minority position through tender offer or open-market purchases. Fourth, potential bidders who must have access to the target's assets to finance an acquisition may be deterred, because of the uncertainty of bid success. If outside financing is necessary to accomplish the acquisition, the bidder's inability to assure quick access to the target's assets may inhibit potential lenders. Fifth, so-called "greenmailers" (such as the Belzbergs in the case of Ashland Oil) may be discouraged by provisions that belie ready access to control. Finally, these provisions may protect target company shareholders against partial tender offers that are "front-end loaded" (bids in which the price of the first-step tender offer is materially higher than the consideration offered in the back-end to remaining shareholders). A "fair price" provision, for example, would attempt to ensure that shareholders relegated to the back-end of a two-step transaction receive the same price as the front-end shareholders, or a "fair price."

There are, of course, many risks in proposing antitakeover amendments. Management may antagonize some shareholders who will view these measures not as devices designed to protect their investment, but as management entrenchment mechanisms. Management must also recognize that should the shark

repellent proposals fail to gain shareholder approval, eroding shareholder support for management may be inferred. This could attract, rather than repel, prospective bidders.

As a caveat, practitioners should note that case law is sparse on the propriety of these article and bylaw amendments, either as a matter of fiduciary concern or with respect to compliance with "technical" provisions. Kentucky case law is virtually nonexistent.

2. Principal Shark Repellent Techniques. The principal advance planning antitakeover techniques involving article or bylaw amendment available under the Kentucky Business Corporation Act are as follows:

a. Restrictions on Changes in the Board of Directors:

1. Stagger the terms of directors.

* If provided by the company's articles of incorporation, the board may be divided into either two or three classes, each class to be nearly as equal in number as possible. If three classes are used, the directors are elected to three year terms. KRS 271A.185. This measure generally increases the number of shares necessary to elect a given number of directors to the board using cumulative voting, as required by Section 207 of the Kentucky Constitution.

Cumulative Voting Formula:
$$X = \frac{A \times B}{C + 1} + 1$$

X = the number of shares required

A = the total voting shares

B = the number of directors desired to be elected

C = the number of directors to be elected

As "C" (the number of directors to be elected) decreases, "X" (the number of shares required to elect any given number of directors) increases.

* Even if the articles provide for classification of the board, such classification is only permitted where the board consists of nine or more members. KRS 271A.185.

2. Limit the manner in which the size of the board may be altered.

* Absent such a measure, a successful bidder could simply increase the number of directors and thereby elect a majority of the board at one annual meeting.

* To restrict the ability of a potential acquirer to change board composition, the articles could be amended to delegate to the board of directors rather than the shareholders the authority to set, increase or decrease the number of directors. This provision would increase a raider's difficulty in packing his representatives on the board by increasing board size. The amendment could provide for the board to fill all vacancies occurring on the board, or, if desired, fill only a stated maximum number of directorships resulting from an increase in the board. See KRS 271A.180 and 271A.190.

3. Increase to a supermajority the shareholder vote required for removal of directors.

* The articles can provide that a supermajority will be required to remove any incumbent director. Absent such a provision, Kentucky corporate law provides that any director or the entire board of directors may be removed, with or without cause, by a vote of the holders of the majority of the shares then entitled to vote at an election of directors. KRS 271A.195(1). If less than the entire board is to be removed, no one of the directors may be removed, if the votes cast against his removal would be sufficient to elect him using cumulative voting. KRS 271A.195(2).

* This technique is most effective when used by a corporation having a classified board. The provision would then permit removal of only those directors in the particular class standing for election, unless the acquiring shareholder owned at least the supermajority amount of the corporation's shares required for removal. The supermajority threshold typically ranges from 66 2/3% to 90%.

* Such higher voting requirements (or "supermajority" provisions) are authorized to be contained in articles of incorporation by KRS 271A.655.

4. Limit the shareholder right to call special meetings of shareholders.

* While KRS 271A.140(3) contemplates that holders of 20% or more of a corporation's shares can call

special shareholder meetings, KRS 271A.655 permits an article amendment to impose greater voting or concurrence requirements.

b. Other Forms of Shark Repellents:

1. Require a supermajority vote to approve business combinations.

* The articles can be amended to require a supermajority shareholder vote to effect mergers, consolidations, sales of assets, reverse stock splits or other extraordinary transactions. This provision effectively enables a corporation exempt from the Kentucky Business Combination Act (KRS 271A.396-399) to impose its own version of KRS 271A.397(1)(a).

* This provision is one of the most popular and effective antitakeover devices because of its absolute provisions. However, some believe shareholders view this as an entrenching mechanism, particularly if the supermajority vote is set at or above 80%.

* To make the supermajority provision more flexible, some amendments permit the target company's board to waive supermajority requirements and reinstate a simple majority, if the board approves of the proposed transaction. Giving the board the power to waive a supermajority vote requirement can create an additional incentive for the bidder to negotiate with the board.

* Supermajority provisions also have disadvantages. If a successful bidder owns, or can obtain the support of the holders of, sufficient shares to satisfy the supermajority requirement, the provisions will be useless to remaining shareholders. Moreover, if no waiver or alternative escape provision is included, outsiders (friendly as well as unfriendly) may be deterred from making a partial tender offer or other partial acquisition proposal that the directors would have considered fair to shareholders. Even if a waiver is permitted, partial acquisition proposals that some shareholders might consider satisfactory may be discouraged by an inability to obtain director approval.

2. Require that an acquisition by an interested shareholder be approved by a majority or supermajority of all disinterested shareholders.

* This effectively enables a corporation excluded from the Kentucky Business Corporation Act to impose its own version of KRS 271A.397(1)(b).

* An "interested shareholder" is typically defined as the beneficial owner, directly or indirectly, of 10% or more of the voting stock of the target corporation.

3. Incorporate a fair price provision that requires a supermajority vote for any business combination between an interested shareholder and the target company, unless the interested shareholder pays a specified fair price for the remaining shares, or the "continuing directors" approve the transaction.

* The "fair price" amendment should cause all shareholders to be treated equally in a two-step transaction.

* The amendment essentially constitutes a contingent supermajority provision which applies only when a significant shareholder proposes a business combination (generally involving a squeeze-out of minority shareholders). The amendment has two typical triggers. First, the level of ownership to trigger status as a significant shareholder must be established. This threshold is usually set between 10% and 40% and is based upon the concept of beneficial ownership as embodied in the securities laws. Second, the supermajority provision for approval of the squeeze-out proposal is generally set at 80% or 90%, or, in some cases, at a majority of the shares not held by the significant shareholder.

* To prevent the significant shareholder from diminishing the value of the minority shareholders' shares after a first-step transaction or otherwise engaging in oppressive conduct, the provision usually requires the higher supermajority vote if (i) dividends are reduced; (ii) additional shares are issued to the significant shareholder; or (iii) significant assets are sold to the significant shareholder.

* The higher voting requirement typically does not apply, if the transaction is approved by a majority of the directors not affiliated with the significant shareholder.

* The fair price provision essentially requires the acquirer to pay the minority shareholders a price at least equal to the highest price the acquirer paid for its shares in the first step of the transaction. The provision

also customarily requires that the consideration paid to the minority shareholders be at least as favorable (i.e., cash) as that paid in the first step. If these requirements are not met, together with certain procedural requirements, then the supermajority vote is required to accomplish the second step, squeeze-out transaction.

* The provision will not, of course, prevent an acquirer who obtains the supermajority number of shares in the first step from consummating the second step of the transaction on his terms, unless the amendment requires a majority or supermajority vote by the minority shareholders.

4. Grant minority shareholders the right to redeem their shares at a specified price, if any person owning, for example, 50% or more of the outstanding common stock of the target has acquired shares pursuant to a tender offer opposed by a majority of the board.

* Any redemption would be limited, however, by KRS 271A.030. Directors must also be concerned with potential liability under KRS 271A.240(1)(b).

5. Authorize the board to consider in evaluating a bid (i) social, economic and other factors beyond the consideration offered for the target company stock; and (ii) constituencies other than the shareholders.

* The Delaware Supreme Court decision in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), discussed infra, suggests that once an active bidding situation arises, the board may not consider these factors without prior shareholder authorization.

* The United States District Court for the Southern District of New York held, however, that when a company is trying to remain independent, its directors are entitled to consider other constituencies; including employees, customers, pension benefits, suppliers and even communities GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016 (S.D. N.Y. 1985).

6. Create a new class of preferred stock, the terms, conditions and issuance of which are at the discretion of the board.

* The articles of a Kentucky corporation can authorize preferred stock which the board of directors may issue with such designations, limitations, relative

rights and preferences as the board establishes at the time of issuance. See KRS 271A.075 and 271A.080.

* The authorized shares could be used for possible financing and acquisition transactions, stock dividends or splits, and other general corporate purposes. Authorization of the preferred stock (typically called "blank check" preferred) increases the company's flexibility by allowing shares to be issued without the expense and delay of a special shareholders meeting.

* A by-product of the authorization is to grant the board greater authority to issue the preferred stock for use in takeover defenses - i.e. issuing shares to purchasers "friendly" to management.

7. Issue to shareholders a dividend of preferred stock or rights to preferred stock redeemable by the shareholders at the highest price paid by an acquirer for target company shares or convertible into common stock of the acquirer at some attractive multiple.

* This technique is a relatively new and rather formidable takeover defense popularly called the "poison pill." It has many variations.

* Most poison pills are triggered - that is, the rights to the preferred stock become exercisable - when a tender offer commences or any shareholder crosses an ownership threshold of, for example, 30% of the target company's shares. Frequently, the board of directors can dismantle the pill by redeeming the rights at a nominal price at any time after adoption of the pill or "rights plan" but before the triggering events.

* The poison pill takeover defense combines features of other strategies, including blank check preferred stock, fair price provisions, rights of redemption and "flip-over" provisions. A flip-over provision purports to make the target company stock convertible into voting equity securities of the acquiring company. The poison pill received the approval of the Delaware Supreme Court in Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985), aff'g 490 A.2d 1059 (Del. Ch. 1985), discussed infra. Since the Household decision, public companies by the dozens have adopted poison pills. Jerrico, Inc. and CONNA Corporation were the first Kentucky companies to adopt poison pills.

* A poison pill plan should enable target shareholders to gain in any appreciation in the acquirer's

shares as a result of the acquisition. These devices cause acquirers to be concerned with both the potential cash drain and dilution of an acquisition and can significantly diminish the attractiveness of front-end loaded, two-tier tender offers.

* Poison pills are exceedingly complex and require utmost care in their implementation. While the poison pill is a most formidable defense, no form of the pill is yet regarded as insurmountable. A successful proxy fight for board control can often enable an acquirer to block the triggering of the key provisions of the poison pill.

B. Other Precautions.

1. Issuance of Shares to Friendly Parties. Assuming there are sufficient shares authorized but not issued and outstanding, the board can cause shares to be issued to persons whom management believes are sympathetic to its views or even subject to standstill agreements. One possibility is to issue shares to an employee stock ownership plan or "ESOP".

2. Dressing Down the Balance Sheet. A potential target company can eliminate "surplus" cash that might attract potential acquirers by acquiring a business, retiring debt or increasing dividends.

3. Stock Repurchase Programs. A potential target company can simultaneously eliminate "surplus" cash and those shareholders most susceptible to buy-out bids by initiating stock repurchase programs. Taken to an extreme, management could attempt to take the company private.

4. Contractual Restrictions. The potential target company can include restrictive provisions in its loan agreements, such as a lender's right of acceleration upon a change in managerial control of the borrowing company.

5. Lock-Ups. The potential target company could grant an option to a favored potential acquirer to buy (a) treasury shares or authorized but unissued shares of the target; or (b) a major target company asset or "crown jewel." Two recent decisions discussed infra, Revlon (previously cited) and Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986) (interpreting N.Y. law), have, however, raised serious doubts about the validity of lock-up options.

6. Golden Parachutes. Golden parachutes are executive compensation agreements in which certain payments are triggered by a change in control of the corporation.

* If such payments exceed three times the average compensation of the executive over the preceding five years, then the difference between the total parachute payment and the executive's average or base compensation is deemed to be an excess parachute payment. The excess parachute payment may not be deducted by the corporation, and the executive must pay a 20% excise tax on the excess payment.

* While these payments can be enormous (for example, the multi-million dollar parachute arrangements adopted by Beatrice Companies, Inc.), the costs are often relatively minor in relation to overall acquisition expense.

* Golden parachute arrangements must be specifically disclosed in proxy statements relating to election of directors; profit sharing, retirement or bonus plans; granting of options; or when action is being taken with respect to antitakeover devices.

C. State Antitakeover Statutes.

Another form of advance planning to discourage or prevent a takeover occurs when a corporation lobbies with the legislature of the state in which that corporation is organized for an antitakeover statute. Although most state takeover statutes were initially enacted as a "second line of defense" for target companies and shareholders of a given state, antitakeover statutes now provide a primary source of protection from hostile parties.

This topic will be discussed in more detail under Section II, infra.

Caveat: This listing of advance planning anti-takeover tactics and strategies is merely illustrative and by no means exhaustive. Of necessity it is also superficial.

II. STATE ANTITAKEOVER STATUTES

A. First Generation Statutes and Edgar v. MITE Corp.

Beginning with an act of the Virginia legislature in 1968, numerous states have adopted takeover or, more aptly, "antitakeover" legislation.

Although the precise provisions varied significantly, the initial or "first generation" antitakeover statutes typically prohibited "nonexempt" stock purchase offers, unless the offeror complied with specified disclosure and substantive requirements. Commonly, the statutes also vested in a state regulatory agency the power to delay or prevent an offering which failed to meet the statutory requirements.

First generation state antitakeover statutes were dealt a severe blow by the Supreme Court decision in Edgar v. MITE Corp., 457 U.S. 625 (1982). In MITE, the Court held the Illinois Business Takeover Act unconstitutional. The Illinois Act applied to target companies of which Illinois shareholders owned at least 10% of the equity securities subject to the offer, or which met two of the following three conditions: (i) the corporation had its principal executive office in Illinois; (ii) the corporation was organized under the laws of Illinois; or (iii) the corporation had at least 10% of its stated capital and paid in surplus represented within the state. The offeror was required to file a registration statement with the Illinois Secretary of State, which statement could not become effective until 20 days after filing. During the 20 day waiting period, the Secretary of State could call a hearing to adjudicate the substantive fairness of the offering. The Secretary of State had to call such a hearing if requested by a majority of the target company's outside directors or by Illinois shareholders owning at least 10% of the securities subject to the offer.

The Supreme Court concluded that the Illinois statute violated the commerce clause of the Constitution, because the statute imposed burdens on interstate commerce which were not justified by the local interests allegedly furthered by the statute.

While placing the enforceability of other state anti-takeover statutes in doubt, the MITE decision created an opportunity for states to remodel their regulatory schemes to pass the balancing test between legitimate local interests and the burdens on interstate commerce.

B. Second Generation Statutes Prior to CTS Corp. v. Dynamics Corp.

1. General Observations. In response to (a) the Supreme Court's determination in MITE that the Illinois anti-takeover statute was unconstitutional and (b) the subsequent invalidation on constitutional grounds of the Missouri, Oklahoma, Virginia, Michigan, Maryland, Florida, Nevada and Pennsylvania antitakeover statutes, many states, including Ohio, Indiana, and Kentucky enacted antitakeover legislation focusing on the more traditional aspects of corporate law in order to withstand constitutional challenge. For example, Indiana and Ohio adopted antitakeover legislation that regulates changes of control primarily by imposing disinterested or super majority shareholder voting requirements with respect to "control share acquisitions." Indiana Code §§23-1-43-1 et. seq.; Ohio Rev. Code Ann. §1701.01(2)(1), 1701.48, 1701.831, 1707.42 (1983). The Indiana and Ohio statutes draw upon the principle of shareholder approval of organic transactions. In contrast to the Illinois statute and its first general counterparts, the Indiana and Ohio anti-takeover laws do not call for administrative hearings or create any role for the Secretary of State or state securities administrator. See subsection C for a more detailed discussion of the Indiana antitakeover statute.

Other examples of post-Mite or "second generation" antitakeover statutes focusing on a corporation's governance or "internal affairs" abound. Maryland enacted a statutory fair price provision imposing supermajority voting requirements on certain transactions with an "interested stockholder," unless the transaction meets certain "fair price" requirements. Md. Corps & Ass'ns Code Ann. §3-602, 3-603(b) (1983).

Pennsylvania amended its corporation law to add provisions similar to the Maryland fair price/supermajority approach. The Pennsylvania law also provides that corporate fiduciaries "may, in considering the best interests of the corporation, consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located, and all other pertinent factors." Pa. Stat. Ann. tit. 15, §§ 408, 409, 1910 (1983).

In December 1985 the New York legislature adopted significant amendments to its business corporation law dealing with hostile takeovers. The amendments deal with disclosure requirements during the takeover, attempt to limit "greenmail" payments and add a new Section 912 which closely resembles the new Section 3 to KRS 271A.397 added by the 1986 Kentucky

General Assembly as part of Senate Bill 337. KRS 271A.397(3) and the other provisions of the Kentucky Business Combination Act will be discussed infra.

Section 912 of the New York Business Corporation Law prohibits for five years any business combination (a broadly defined term) between a resident domestic corporation and an interested shareholder, unless certain conditions are met. The principal condition which must be met to avoid the five-year prohibition is approval for the proposed interested business combination by the target company board of directors. Absent such board approval or approval by disinterested shareholders of a bylaw amendment opting out of Section 912, an interested shareholder must wait five years before entering into an interested business combination with a non-exempt New York corporation. Significantly, the bylaw amendment cannot become effective until eighteen months after the shareholder vote.

After five years, the interested shareholder must still overcome other obstacles to enter into interested business combinations. He must either receive a majority of disinterested shareholder approval for the combination or provide for a payment to the remaining shareholders at a price which will generally be the highest price paid by the interested shareholder for previously acquired shares. Excluded from the provisions of Section 912 are business combinations of, inter alia: (i) corporations that do not have voting stock registered with the Securities and Exchange Commission; (ii) corporations whose original certificate elects not to be governed by Section 912; (iii) corporations adopting prior to March 31, 1986 a bylaw amendment opting that out of Section 912; (iv) corporations with inadvertent interested shareholders who divest themselves of enough shares to bring them below the 20% interested shareholder threshold; and (v) corporations with an interested shareholder who owned 5% or more of the stock as of October 30, 1985. See N.Y.B.C.L. Section 912(d).

2. Kentucky Business Combination Act As Amended. Roughly two years after the MITE decision, the Kentucky General Assembly enacted, with a July 13, 1984 effective date, the Kentucky Business Combination Act (the "Act"). KRS 271A.396-399. The Act is a unique blending of elements in the second generation statutes of other states. For example, the "Ashland Oil" amendment to the Act, KRS 271A.397(3), closely resembles New York's Section 912 and Indiana's Section 20.

For purposes of the Act, "business combination" means:

* Any merger or consolidation of a target corporation or any subsidiary with any interested shareholder or with any other corporation which, after the merger or consolidation, would be an affiliate of the interested shareholder; provided, however, that a merger or consolidation which does not alter the contract rights of stock as expressly set out forth in the target company's articles of incorporation or which does not change or convert any of the outstanding shares of the target corporation's stock does not constitute a "business combination."

* Any sale, lease, transfer or other disposition, other than in the ordinary course of business, in a single transaction or series of transactions in any twelve month period, to any interested shareholder or any affiliate of an interested shareholder, of target corporation assets having an aggregate book value equal to or exceeding 5% or more of the total market value of the target corporation's stock or target corporation's net worth at the end of its most recently ended fiscal quarter.

* Issuance or transfer by the target corporation or a subsidiary to any interested shareholder or affiliate of any interested shareholder, in a single transaction or series of transactions in any twelve month period, of any equity securities of the target corporation or any subsidiary which have an aggregate market value of 5% or more of the total market value of the target corporation's outstanding stock, determined at the end of the corporation's most recently ended fiscal quarter prior to the first such issuance or transfer.

* Adoption of any plan or proposal for the liquidation or dissolution of the corporation in which anything other than cash will be received by an interested shareholder or affiliate of the interested shareholder.

* Any reclassification of securities by the target corporation, including any reverse stock split; any recapitalization of the corporation; any merger or consolidation of the corporation with any of its subsidiaries, such as under KRS 271A.375; or any other transaction having the effect, directly or indirectly, in a single or series of transactions, of increasing by 5% or more the proportion of the amount of the outstanding shares of any class of the corporation's equity securities, directly or indirectly, beneficially owned by any interested shareholder or an affiliate of any interested shareholder. KRS 271A.396(4).

Significantly, the definition of "business combination" does not include tender offers or creeping open market acquisitions of shares.

For purposes of the Act, "interested shareholder" means any person other than the target corporation or any of its subsidiaries who:

* Beneficially owns, directly or indirectly, 10% or more of the target corporation's outstanding voting stock.

* Controls, directly or indirectly, or is under common control with the corporation and who at any time within the two year period immediately prior to the date in question was the beneficial owner, directly or indirectly, of 10% or more of the corporation's outstanding voting stock. KRS 271A.396(9)(a).

For purposes of determining whether a person is an interested shareholder, the number of shares of voting stock deemed to be outstanding include shares beneficially owned by the prospective interested shareholder through application of the broadly drafted beneficial ownership provisions of KRS 271A.396(3), which focus on voting rights; provided, however, that shares of voting stock which may be issued under any agreement, arrangement or understanding or exercise of conversion of a warrant or options are not included in the calculation of outstanding shares of voting stock. KRS 271A.396(9)(b).

Assuming a Kentucky corporation is not exempt from the Act under KRS 271A.398, a purported business combination with such corporation shall be void, unless:

* In addition to any vote otherwise required by law or the articles of incorporation of the target corporation, the business combination is recommended by the target corporation's board of directors and approved by the affirmative vote of at least (a) 80% of the votes entitled to be cast by outstanding shares of voting stock of the corporation, voting together as a single voting group; and (b) two-thirds of the vote entitled to be cast by holders of voting stock other than voting stock beneficially owned (i) by the interested shareholder who is, or whose affiliate is, a party to the business combination, or (ii) by an affiliate or an associate of such interested shareholder, voting together as a single voting group. See KRS 271A.397(1) and (2).

The supermajority voting requirements of KRS 271A.397(1) do not apply to a business combination if:

* The fair price provisions of KRS 271A.398(2) are met.

* The business combination has specifically been approved or exempted from KRS 271A.397(1) by resolution of the target corporation's board of directors (a) within two months after July 18, 1984 (the effective date of the Act) or such earlier date as may be irrevocably established by board resolution; (b) at any time prior to the time the interested shareholder first became an interested shareholder; (c) at any time such business combination is approved by a majority of the continuing directors at a meeting of the board of directors of the target corporation at which a quorum consisting of at least a majority of the continuing directors is present. KRS 271A.398(3).

For purposes of the Act, a "continuing director" means any member of the board of directors who is not an affiliate or associate of an interested shareholder or any of its affiliates and who was a director of the corporation prior to the time the interested shareholder became an interested shareholder. The term also includes any successor to such continuing director who is not an affiliate or associate of the interested shareholder or any of its affiliates and who was recommended or elected by a majority of the continuing directors at a meeting at which a quorum consisting of the majority of the continuing directors is present. KRS 271A.396(6).

The supermajority voting requirements of KRS 271A.397(1) also do not apply to a business combination of a corporation that on July 13, 1984 had an existing interested shareholder, whether or not the business combination is with that existing interested shareholder or with any other person who becomes an interested shareholder after July 13, 1984. However, that exemption can be eliminated, if (a) the target corporation's board of directors elects by resolution to be subject, in whole or in part, to the requirements of KRS 271A.397(1) and (2); or (b) the articles of incorporation or bylaws of the target corporation specifically provide otherwise. See KRS 271A.398(4).

Perhaps most significantly, the requirements of KRS 271A.397 (subsections 1, 2 or 3) do not apply to any business combination of:

* A corporation having fewer than 500 beneficial owners of its stock (this excludes all but a few Kentucky corporations);

* A corporation whose articles, originally or by an amendment approved by at least 80% of all shareholders and by two-thirds of all disinterested shareholders, expressly elect not to be governed by KRS 271A.397; or

* An investment company registered under the federal Investment Company Act of 1940, as amended; a bank or a bank holding company as defined in the federal Bank Holding Company Act of 1956, as amended; a savings and loan company under the federal Savings & Loan Holding Company Amendments of 1967, as amended; and a domestic insurer as defined under KRS 304.1-070. See KRS 271A.398(5)(a).

Unless the business combination is excluded under KRS 271A.398(5)(a), by virtue of the "Ashland Oil" amendment (the "Amendment") to the Act passed by the 1986 General Assembly, no for-profit Kentucky corporation shall engage in any business combination with any interested shareholder for a period of five years following the date on which the interested shareholder became an interested shareholder, unless the business combination is approved by the target corporation's board of directors prior to the date on which the interested shareholder became an interested shareholder. KRS 271A.397(3).

Significantly, a party already characterized as an interested shareholder prior to the effective date of the Amendment cannot avoid the five year statutory prohibition on business combinations, except through the exemptions available under KRS 271A.398(5)(a).

For purposes of KRS 271A.397(3) only, the term "business combination" includes, in addition to the meaning ascribed to it under KRS 271A.396(4), any receipt by an interested shareholder or an affiliate or associate of an interested shareholder of the benefit, directly or indirectly, of any loans, advance, guarantees, pledges or other financial assistance or any tax credits or other tax advantages provided by or through the target corporation. KRS 271A.397(3).

If the interested shareholder/would-be-acquirer makes a good faith proposal in writing to the board of directors of the target corporation regarding a business combination, the target corporation's board of directors shall respond, in writing, within thirty days or such shorter period as may be required by the Securities Exchange Act of 1934 describing and justifying its decision regarding the proposed business combination.

The Amendment became effective March 28, 1986. At the risk of oversimplification, the importance of the Amendment is that, for a Kentucky corporation having more than 500 beneficial owners (a term broader than shareholders of record) and not otherwise excluded by KRS 271A.398(5)(a), no third party may accomplish a "business combination" with that corporation without board approval prior to the time the third party acquires 10% or more of the target corporation's stock. The Amendment also specifically addresses and seeks to restrict the immediate financing of a hostile acquisition using the assets of the target corporation. This provision takes aim at the Belzbergs, Carl Icahn, Sir James Goldsmith, Irwin Jacobs, William Clyde Engle, T. Boone Pickens, and other famed or infamous corporate raiders, such as Ivan Boesky.

The enforceability of the Kentucky statute has not yet been determined. However, recent court decisions involving the antitakeover legislation of other states, including that of Ohio and Indiana, suggest that the Kentucky statute could withstand judicial scrutiny.

C. Second Generation Statute Withstands Constitutional Challenge: CTS Corp. v. Dynamics Corp. of America

The April 21, 1987, U.S. Supreme Court decision of CTS Corp. vs. Dynamic Corp. of America, 481 U.S. _____ (1987, 107 S.Ct. 1637), reversed a long trend in which second generation state antitakeover laws routinely succumbed, in lower federal courts, to constitutional challenge. The Dynamics decision addresses the constitutionality of the Indiana "control share acquisition" statute.

The Control Share Acquisition Chapter of the Indiana Business Corporation Law (Ind. Code §§23-1-43, et. seq.) was enacted in March 1986 and became generally effective August 1, 1987. The law applies to any "issuing public corporation" organized in Indiana, unless the company amends its articles of incorporation or bylaws to "opt out" of coverage. Conversely, by resolution of the board of directors, an Indiana corporation could have taken advantage of the law's protection prior to August 1, 1987.

The Indiana act defines an "issuing public corporation" as an enterprise incorporated in Indiana which has:

- 100 or more shareholders;
- Its principal place of business, principal offices, or substantial assets within Indiana; and

- Either more than 10 percent of its shareholders residing in Indiana, more than 10 percent of its shares owned by Indiana residents, or more than 10,000 shareholders residing in Indiana.

The Indiana act applies to purchases of "control shares," defined in the statute as shares purchased by an acquirer, which would give the acquirer voting power at or above any of the following thresholds: 20 percent, 33 1/2 percent, or 50 percent. An acquirer may not acquire voting rights to the "control shares" unless a majority of disinterested shareholders holding each class of the corporation's stock votes to confer that authority. In general, a disinterested shareholder is not:

- An acquirer, or a member of an acquiring group participating in a control share acquisition;
- An employee who is also a director of the target corporation; or
- An officer of the target.

Disinterested shareholders must decide whether to confer voting rights upon the "control shares" at the next regularly scheduled shareholders' meeting or at a special meeting. If the acquirer requests a special meeting and agrees to pay the associated expenses, target company management must hold the session within 50 days of the acquirer's filing of an "acquiring person's statement." If the disinterested shareholders withhold voting rights, the target corporation may, but is not required to, redeem the control shares from the acquirer.

Hence, the Indiana act effectively conditions a bidder's acquisition of corporate control on approval by a majority of shareholders, exclusive of the bidder and target management.

On March 10, 1986, Dynamics Corp. of America, which owned 9.6% of the outstanding common stock of CTS Corp., announced a tender offer for an additional one million CTS shares. The purchase would have increased Dynamics' ownership in CTS, an Indiana corporation, to 27.5%.

As part of its effort to frustrate Dynamics' tender offer, the CTS Corp. board of directors on March 27, 1986, elected to become subject to the three-week old Indiana act. Eight days later, Dynamics alleged, in a complaint filed with

the U.S. District Court for the Northern District of Illinois, that the federal Williams Act governing tender offers preempted the Indiana act and that the Indiana act violated the commerce clause of the U.S. Constitution. The District Court declared the Indiana act unconstitutional, and the Court of Appeals for the Seventh Circuit affirmed that decision.

By a vote of 6-3, the Supreme Court reversed the decision of the Seventh Circuit, holding that the Williams Act did not preempt the Indiana act. The Court concluded that:

- An offeror could comply with both the Williams Act and the Indiana act; and
- The Indiana act furthers the purposes of the Williams Act by favoring neither management nor an offeror, but by protecting shareholders against the contending parties.

The court reasoned that a contrary holding would mean that the Williams Act preempted many other state corporate laws of previously unquestioned validity.

The Supreme Court also held that the Indiana act did not violate the commerce clause. The Court found that the Indiana act did not discriminate against or adversely affect interstate commerce because it:

- Equally affects all offerors, whether or not an Indiana domiciliary;
- Does not subject corporate activities to inconsistent regulation, since only Indiana law will govern the voting rights of corporations organized in that state; and
- Although potentially hindering some tender offers, regulates companies whose "very existence and attributes are products of state law."

The decision emphasized that every state had enacted laws regulating corporations within their respective borders and that each state has an interest in "promoting stable relationships among parties involved in the corporations it charters."

Thus, the Dynamics decision dramatically reaffirmed the "internal affairs doctrine," which asserts the primacy of state regulation of corporations generally and the voting rights of shareholders in particular. This landmark "state's rights" decision most assuredly invites the several states to enact legislation similar to the Indiana act, and perhaps it encourages bolder legislatures to experiment with any other antitakeover law which the internal affairs doctrine can or might justify. Following the Dynamics decision, many states have adopted new antitakeover statutes similar to that of Indiana's. The list includes Arizona, California, Minnesota, North Carolina and Delaware. Hence, the Dynamics decision has proven to be an important victory for companies seeking protection from hostile takeovers.

D. Delaware: Most Recent Second Generation Antitakeover Statute Enacted

On February 2, 1988, Governor Castle of Delaware signed into law an antitakeover statute similar to the New York "business combination" statute, only less harsh with respect to potential acquirers. The Delaware statute provides that a Delaware corporation may not engage in any "business combination" for a period of three (3) years with any "interested stockholder" unless the conditions set forth below are satisfied. A "business combination" includes, in general, mergers, certain sales of assets or stock, and other similar transactions. An "interested stockholder" is defined to include a stockholder holding (together with affiliates and associates) in excess of 15% of the outstanding voting stock of a Delaware corporation.

An interested stockholder may not engage in a business combination for three years unless:

(1) The board of the Delaware corporation approves the business combination with the interested stockholder or gives prior approval with respect to the transaction in which the stockholder becomes an interested stockholder;

(2) The interested stockholder acquires at least 85% of the Delaware corporation's voting stock in the same transaction in which the person becomes an interested stockholder (excluding for this calculation, voting stock held by (a) the Delaware corporation's directors who are also officers and (b) certain employee stock plans); or

(3) The business combination that is approved by the affirmative vote of stockholders holding at least 66 2/3% of the outstanding voting stock of the

Delaware corporation (excluding the voting stock held by the interested stockholder).

The Delaware antitakeover statute automatically applies to Delaware corporations with 2,000 or more stockholders of record or which has voting stock listed on a national exchange or listed for quotation with a registered national securities association. The statute will not apply, however, under the following circumstances:

(1) The Delaware corporation's original certificate of incorporation contains a provision electing not to be governed by the statute;

(2) The Delaware corporation, by action of its Board of Directors, adopts an amendment to its bylaws within 90 days of the effective date of the statute, expressly electing not to be governed by the statute;

(3) The Delaware corporation, by action of its stockholders, adopts an amendment to its certificate of incorporation or bylaws expressly electing not to be governed by the statute. This amendment to the certificate of incorporation or bylaws will not be effective until 12 months after the adoption of such an amendment;

(4) The "business combination" is proposed prior to the consummation, or abandonment of, and after public announcement of, certain transactions (including mergers, sales of 50% or more of the assets, or tender offers for 50% or more of the voting common stock) involving the Delaware corporation and either a person who (a) was not an interested stockholder during the previous three years or (b) became an interested stockholder with the approval of the Board of Directors and the transaction with the third party was approved or not opposed by a majority of the members of the Board of Directors of the Delaware corporation; and

(5) The interested stockholder who owns shares in excess of the 15% limitation acquired such shares prior to December 23, 1987, or acquired such shares pursuant to a tender offer commenced prior to December 23, 1987.

The Delaware statute represents an interesting twist on the typical "business combination" statute in that the

restrictions of the statute are inapplicable if another acquiring party becomes involved.

III. BUSINESS JUDGMENT RULE IN THE TAKEOVER CONTEXT

A. Traditional Notions of Management Responsibility.

1. General. The legal obligations of directors and officers under state law fall into two broad categories: a duty of loyalty and a duty of care. The duty of loyalty mandates that directors and officers not use their positions to reap personal profits at the expense of the corporation. It prohibits directors and officers from usurping corporate opportunities, and it further prohibits directors and officers from entering into unfair transactions or contracts with the corporation.

The duty of care requires directors and officers to act in good faith or with the care of an ordinary prudent person in like position under similar circumstances. The duty of care includes the responsibility of directors (i) to oversee the activities of the corporation by attending directors meetings; (ii) to obtain adequate information upon which to make decisions; (iii) to review that information carefully; and (iv) to monitor the activities which are delegated to officers of the corporation.

Nearly two-thirds of all states have codified the duty of loyalty by enacting statutes controlling director conflict of interest transactions. Most, including KRS 271A.205, parallel Section 41 of the Model Business Corporation Act.

At common law, the modern rule on the duty of loyalty generally provides that a conflict of interest transaction will be upheld, if, after close scrutiny by the court, the transaction is fair to the corporation. The requirement of strict judicial scrutiny insures that, in the absence of arms-length bargaining, the interested director will not, even through mistake or inadvertence, obtain an unfair advantage.

More than half of the states have enacted statutes codifying the duty of care. Many state statutes are patterned after Section 35 of the Model Business Corporation Act which states, in part: "A director shall perform his duties . . . - in good faith, in the manner he reasonably believes to be in the best interest of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances."

Kentucky and Delaware are among the minority of states which have not enacted a specific statute concerning the duty of care. (However, legislation pending in the 1988 Kentucky General Assembly would, if enacted, codify a standard of conduct for directors and officers.) In Delaware, directors are bound to use that amount of care which "ordinarily careful and prudent men would use under similar circumstances." Graham v. Allis - Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. Ch. 1963).

Kentucky comes close to codifying a standard of conduct for directors in KRS 271A.026 on indemnification of directors. KRS 271A.026(2) provides that the corporation shall have the power to indemnify a director, if (a) he conducted himself in good faith; and (b) he reasonably believed that his conduct was in the best interests of the corporation. At common law, Kentucky courts have characterized directors and officers as fiduciaries to reinforce, but not to clarify, the duties of care and loyalty to the corporation. Macon Lumber Co. v. Bishop & Collins, 229 F.2d 305 (6th Cir. 1956); Acree v. E.I.F.C., Inc., 502 S.W. 2d 43 (Ky. Ct. App. 1973).

There are relatively few reported decisions in which directors are held liable for violation of the state law duty of care. The traditional insulation of the board can, in many respects, be attributed to the long standing common law creation known as the "business judgment rule." The business judgment rule constitutes the principal defense of directors and officers when third party or shareholder derivative actions challenge decisions of corporate management, including responses to takeovers.

The business judgment rule provides that directors are not insurers, and that, if they act in good faith with due care, directors will not be held liable for mere mistakes or errors of judgment. See, e.g., Levitan v. Stout, 97 F.Supp. 105 (W.D. Ky. 1951). The rule is often expressed as a presumption that the decision of the directors or officers is proper. See, e.g., Levitan, supra, and Davis v. Louisville Gas & Electric Co., 142 A. 654 (Del.Ch. 1928).

If the business judgment rule applies, the plaintiff bears the burden of proving the impropriety of the transaction under attack. Although the rule is generally phrased in terms of directors, it applies to actions and decisions of corporate officers as well. See, e.g., Kaplan v. Centex Corp. 284 A.2d 119 (Del. Ch. 1971).

The generally cited elements of the business judgment rule are:

- * Absence of personal interest or self-dealing.
- * An informed decision.
- * A reasonable belief that the action taken serves the corporation's best interests.
- * Good faith.

B. Evolution Of New Standards For Boards Of Directors Responding To Takeovers: Significant Recent Decisions.

1. Introduction. Against the backdrop of traditional judicial reluctance to interfere with the exercise of business judgment by corporate directors in the absence of fraud, bad faith, gross overreaching or abuse of discretion, and against the traditional use of the business judgment rule as a rebuttable presumption that corporate directors have acted in good faith, the recent wave of takeovers has apparently fostered a wave of judicial activism. While Kentucky courts are silent on the duties and defenses of directors in the takeover context, Delaware courts have maintained their historic high profile by rendering a series of momentous decisions on that subject.

2. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). In Van Gorkom, the Delaware Supreme Court held the directors of Trans Union Corp. personally liable for gross negligence in approving the acquisition of their company by Chicago investors Jay and Robert Pritzker. The plaintiffs in the case were disappointed Trans Union shareholders who claimed the \$55 per share merger price, which represented a 45% premium over the then \$38 market price, was less than the "intrinsic value" of the Trans Union shares. The plaintiffs made no allegations of fraud, bad faith, self-dealing or entrenchment by the Trans Union board.

The plaintiffs succeeded in this derivative action, not because the directors made a wrong judgment on the price, but because the court concluded that the directors were so unprepared and acted so hastily that they could not, and really did not, make an informed business judgment. The directors relied exclusively on a 20 minute presentation by the chairman and chief executive officer; there existed no written summary of the merger terms, nor any documentation supporting the price. The directors did not consult management, counsel, or an investment banker. Hence, the Delaware court did not second guess the merits of any decision made by the directors, but the process by which the directors made their decision.

In essence, the Delaware Supreme Court, through Van Gorkom, has served notice on corporate directors that the

"clean hands/pure heart" defense is inadequate. Other parts of the directors' anatomies -- i.e. their brains -- must be actively engaged. Even in the absence of improper motive, directors can be held liable if they fail to demonstrate that they were adequately advised and took sufficient time to consider the alternatives.

3. Moran v. Household International, Inc., 500 A. 2d 1346 (Del. 1985). On the same day the Delaware Supreme Court rendered its decision in Van Gorkom, the Delaware Chancery Court approved a bold anti-takeover device adopted by the board of directors of Household International. Moran v. Household International, Inc., 490 A.2d 1059 (Del. Ch. 1985). The Delaware Supreme Court subsequently upheld the Chancery Court's ruling approving Household's warrant dividend plan or "poison pill." Some commentators estimate that, by the end of 1988, the Household decision will have led to the adoption of poison pills by 1,000 American corporations.

Although no pending or threatened hostile bid existed, the Household board adopted a poison pill rights plan with a flip-over feature, because the board perceived that Household was vulnerable to takeover threats. The rights plan involved issuance to each common shareholder of a right to purchase 1/100th of a preferred share for \$100. Ten days after the announcement of a tender offer for 30% of Household's stock or the acquisition of a 20% interest by any entity or group, the rights would become immediately exercisable and transferrable separately from the common stock. The preferred stock rights were redeemable by the Household board for a nominal sum before the occurrence of either trigger and after the occurrence of the 30% trigger.

If Household were to be the surviving corporation in a merger in which its common stock was unchanged, each right would entitle its holder to purchase for \$100 Household common stock having a market value of \$200. However, if Household was not the surviving corporation, a "flip-over" provision entitled the holder to purchase for \$100 common stock of the acquirer having a market value of \$200.

The Delaware Supreme Court held that the Household board had adequate authority to issue both the rights and, upon exercise, the underlying preferred stock. The court cited the Delaware statute granting the board of directors the power to create and issue rights or options to purchase shares of capital stock, subject to limitations in the corporation's charter. Delaware General Corporation Law Section 157.

The Delaware court refused to limit the statute to stock issuances for corporate financing as opposed to takeover defense and cited the board's inherent management power under Delaware General Corporation Law Section 141(a).

The court further concluded that the board had acted in good faith by conducting a reasonable investigation, by consulting with takeover counsel and investment bankers and by no means acting as hastily as their Trans Union counterparts in Van Gorkom. The majority opinion applauded the Household board's decision to plan for the contingency of a hostile takeover rather than to respond, perhaps unwisely, under the pressure of a hostile bid. The opinions specifically approved the basis on which the board acted: concern over the increasing frequency in the financial services industry of "bootstrap" or "bust-up" takeovers. The court was satisfied that the poison pill was a reasonable response to the threat posed and that the board received a full and candid evaluation of the plan from knowledgeable and experienced advisors.

4. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). In Unocal, the Delaware Supreme Court delivered a crushing blow to raider T. Boone Pickens, when it upheld an exchange offer by Unocal which excluded Mesa.

Mesa affiliates owned 13% of Unocal's stock when it made a hostile cash tender offer for an additional 37% at \$54. Mesa stated its intention to merge out the remaining shares for subordinated securities worth \$54. In response, Unocal offered to exchange a package of senior debt securities valued at \$72 per share for 49% of Unocal stock for the dual purposes (a) of defeating the Mesa offer, which the Unocal board rejected as inadequate, and (b) should Mesa nevertheless succeed, to provide what the board considered fair value for the remaining shares.

The Unocal board excluded Mesa, because Mesa sales to Unocal would effectively have subsidized Mesa's offer and, under the Securities and Exchange Commission's proration requirements, every share purchased from Mesa would have been one less purchased from the other tendering shareholders. The Delaware court upheld the discriminatory exchange offer, concluding that the board was not relegated to a passive role. The board had authority to manage the corporation's affairs under Delaware General Corporation Law Section 141(a) and authority to deal in Unocal's stock under Delaware General Corporation Law Section 160(a). The court also cited the Unocal board's fundamental duty and obligation to protect the corporate enterprise from harm reasonably perceived, whatever its source.

The Delaware court further stated that, since the board had the same responsibility in responding to a takeover threat as it did in other matters, its decision was entitled to no less deference. However, because of the risk of entrenchment motivated action, the board had a special initial burden of showing reasonable grounds for believing that a danger to corporate policy and effectiveness existed. The board could discharge this burden by showing the directors undertook a good faith reasonable investigation. The court observed that the Unocal board had the additional burden of showing that the defensive measure was reasonable in relation to the threat posed. Assuming the board discharged these initial burdens, the ultimate burden of showing a breach of fiduciary duty shifted to the plaintiff.

The court found that Unocal's board had discharged these burdens. As to good faith and reasonable investigation, the board approved the exchange offer after two lengthy meetings in which detailed management, investment banking and legal presentations were made. The outside directors met separately with the lawyers and investment bankers, and the directors were advised by Delaware counsel that Mesa could be excluded for what they reasonably believed to be a valid corporate purpose. The court looked favorably upon the fact that a majority of the board members were independent directors who actively investigated and analyzed the issues facing the board.

As to balance, the court found the purposes of the offer to be proper in light of the perceived threat of a grossly inadequate two-tiered tender offer coupled with a threat of "greenmail." It also found the Unocal discriminatory exchange offer was reasonably related to the threat posed, given the track record of Mesa as a corporate raider.

5. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., No. 353 & 354, slip op. (Del. March 13, 1986). This case addressed the well publicized dispute among Revlon, Inc., Forstmann Little & Co. and Pantry Pride, Inc., and dealt a severe blow to the use of asset lock-ups in takeover battles.

Following several meetings between representatives of Pantry Pride, Inc. and Revlon, Inc. concerning the former's interest in acquiring the latter, the Revlon board approved two defensive tactics: a "poison pill" rights plan and a repurchase of stock with new Revlon notes containing restrictive covenants tailored to prevent a takeover.

After a series of bids by Pantry Pride ended with a bid of \$53 cash per share, the Revlon board approved a leveraged buy-out agreement with Forstmann Little, which involved par-

ticipation of Revlon's management, at \$56 cash per share. The board also agreed that, with respect to Forstmann Little, Revlon would redeem the poison pill and waive the restrictive note covenants. Pantry Pride then raised its offer to \$56.25 cash per share.

Forstmann Little immediately raised its bid to \$57.25 per share (this time in cash and paper without management participation) and agreed to support the value of the notes that had fallen in price as a result of the waiver of the covenants. In return, Forstmann Little demanded and was given a lock-up option to buy two key divisions of Revlon for \$525,000,000 (which Revlon's own investment banker valued \$75,000,000 higher) in the event another person acquired 40% of Revlon's shares.

This asset lock-up proved to be a fatal move by Revlon management and Forstmann Little. When the dispute reached the Delaware Supreme Court for the last time, the court ruled that the directors of Revlon violated their fiduciary duties by granting the lock-up option to Forstmann Little. The Delaware court began its analysis by reciting principles of Delaware law developed in the Van Gorkom, Household and Unocal decisions. The court stated that "while the business judgment rule may be applicable to the actions of corporate directors responding to takeover threats, the principles upon which it is founded -- care, loyalty and independence -- must first be satisfied." Id.

Noting that the business judgment rule ordinarily provides a presumption in favor of the directors, the court reiterated the concern expressed in Unocal that when the board adopts any takeover tactics, there is the "omnipresent spectre that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders." Id. at 13. The court continued

This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation In addition, the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance -- that the responsive action taken is reasonable in relation to the threat posed.

Id. at 13.

After approving the board's initial defenses (the issuance of the poison pill, thereafter redeemed, and the exchange offer), the court turned to the lock-up option. They concluded that, upon Pantry Pride's bid of \$53 and the Revlon board's authorization of merger negotiations, "the duty of the board changed from preservation of Revlon's corporate entity to maximization of the company's value at a sale for the stockholders' benefit." Id. at 17. In other words, the directors changed from "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." Id. at 17.

The court then held that "When the Revlon board entered into an auction ending lock-up agreement with Forstmann . . . , the directors breached their primary duty of loyalty." Id. at 18.

Although the court's conclusion that the Revlon board breached its duty of loyalty could have ended the matter, the court also found a breach of the duty of care. Citing the Second Circuit's opinion invalidating an asset lock-up in Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2nd. Cir. 1986), the Delaware court stated that the Revlon board's "principal object, contrary to the board's duty of care, appears to have been protection of the noteholders over the shareholders' interests." Id. at 22.

6. Ivanhoe Partners v. Newmont Mining Corporation, Fed. Sec. L. Rep. (CCH) ¶ 93,552 (Del. Sup. Ct., November 18, 1987). In another decision thwarting the takeover efforts of T. Boone Pickens, the Delaware Supreme Court upheld Newmont Mining Corporation's tactics to avoid Ivanhoe Partners' takeover attempt under the fiduciary obligations established in the Unocal and Revlon decisions. In Ivanhoe, Newmont attempted to block a hostile tender offer by Ivanhoe Partners by (i) declaring a dividend to all its shareholders, which helped its largest shareholder, Consolidated Gold Fields ("Gold Fields") engage in a street sweep of Newmont stock. The street sweep, the dividend, and a standstill agreement between Newmont and Gold Fields would effectively defeat Ivanhoe's bid.

Ivanhoe sought to enjoin Newmont's actions arguing that they violated Newmont's and Gold Fields' fiduciary duties to Newmont shareholders.

The Delaware Supreme Court refused to enjoin the actions and applied the business judgment rule, citing Unocal and Revlon. The court rebuffed the claim that the use of corpo-

rate assets to entrench Newmont's management violated the duty of loyalty owed by Newmont directors to the shareholders. The court stated that the evidence did not support the claim that the transactions were a scheme to entrench management, and held that the Newmont board's responses to the takeover were reasonable.

The court stressed that the Gold Fields' directors did not participate in the Newmont board meeting while the board considered its response to Mr. Pickens' bid. The court found that under the circumstances, the board action taken by a majority of independent directors came under the protection of the business judgment rule.

7. General Observations. What appears to be emerging from these cases is a distinction between "enterprise issues" and "ownership issues" in the application of the business judgment rule. Traditional deference to the judgment of directors and traditional application of the business judgment rule as a shield to protect directors from liability continues for enterprise issues. An example of an enterprise issue would be a decision by a board to expand a company's operations, make personnel changes, or purchase new plant and equipment.

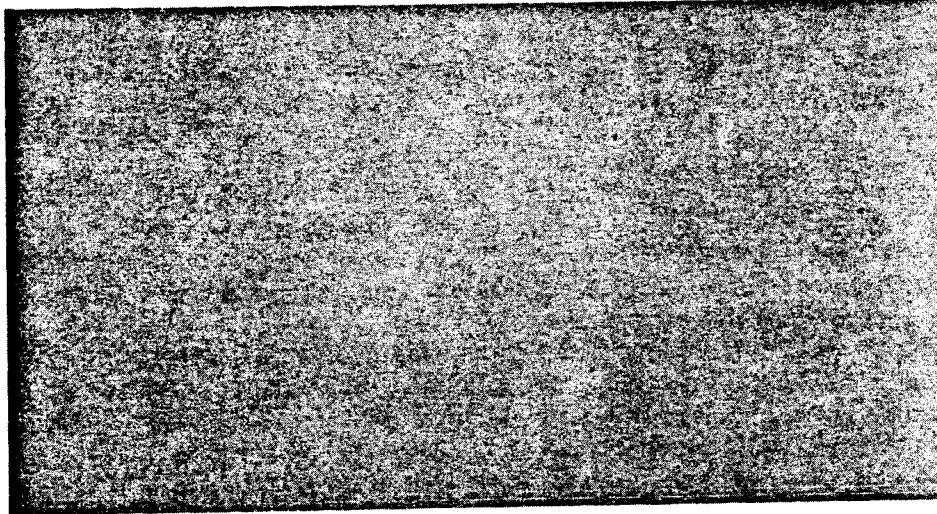
However, when a board decision has a direct impact on stock ownership -- for example, a decision on a stock issuance, redemption or merger -- the board may expect less judicial deference and greater judicial scrutiny, should that decision be challenged by a third party or shareholders. To withstand that scrutiny, the directors must be able to document a deliberate, focused, prepared, counselled, and generally professional decision.

In the enterprise issue case, the court will uphold the board's decision if it can be attributed to any rational business purpose. If an ownership issue is involved, the directors must show they exercised their business judgment with due care, and the substance of the decision must meet the court's standard of reasonableness.

Jay Middleton Tannon

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**How the Indiana Decision
Widened State Powers in Takeovers**

State Legal Powers

Did the Indiana Decision Buoy Takeover Regulation?

Jay Middleton Tannon and Cynthia L. Stewart

In upholding Indiana's control share acquisition law, the U.S. Supreme Court has strengthened the power of states to regulate takeovers if shareholders are given a voice in the process. Bolder legislative initiatives could lead to judicial rejection, which was the fate of most earlier statutes.

THE U.S. SUPREME COURT decision upholding Indiana's control share acquisition law has dramatically improved the prospects for, and the profile of, state antitakeover statutes. The April 21, 1987, decision in *CTS Corp. v. Dynamics Corp. of America*¹ reversed a tide in which state antitakeover laws had succumbed routinely to legal challenges usually brought by hostile bidders. First generation antitakeover statutes disappeared in the wake of *Edgar v. MITE Corp.*,² a 1982 Supreme Court decision that declared the Illinois Business Takeover Act unconstitutional. After that, second generation statutes were yielding, in the lower federal and state courts, to constitutional challenges by hostile parties.

The *Dynamics* decision has, however, provided state legislators with renewed justification for using state corporation laws to help companies within

their respective states fend off hostile takeover attempts. Hence, the *Dynamics* decision could bolster the defensive arsenals of target companies in states which adopt antitakeover statutes.

This article will review the *Dynamics* decision, assess its probable impact, examine the history and principal forms of state antitakeover statutes, and survey antitakeover law developments in certain key states.

The Control Share Acquisition Chapter of the Indiana Business Corporation Law was signed into law March 4, 1986, by Gov. Robert Orr. The Indiana act applies, as of August 1, 1987, to any corporation organized in Indiana, unless the company amends its articles of incorporation or bylaws to "opt out" of coverage. Conversely, by resolution of the board of directors, an Indiana corporation could have taken advantage of the law's protection prior to August 1, 1987.

The Indiana act applies to an "issuing public corporation," which the statute defines as an enterprise incorporated in Indiana and having:

- 100 or more shareholders;
- Its principal place of business, principal offices, or substantial assets within Indiana; and
- Either, more than 10 percent of its shareholders residing in Indiana, more than 10 percent of its shares owned by Indiana residents, or 10,000 shareholders residing in Indiana.

The Indiana act applies to purchases of "control shares," defined in the statute as shares purchased

Jay Middleton Tannon and Cynthia L. Stewart practice law with Brown Todd & Heyburn in Louisville, Ky.

by an acquirer, which would give the acquirer voting power at or above any of the following thresholds: 20 percent, 33⅓ percent, or 50 percent. An acquirer may not acquire voting rights to the "control shares" unless a majority of disinterested shareholders holding each class of the corporation's stock votes to confer that authority. In general, a disinterested shareholder is not:

- An acquirer, or a member of an acquiring group participating in a control share acquisition;
- An employee who is also a director of the target corporation; or
- An officer of the target.

Stockholders have the balance of power

The disinterested shareholders must decide whether to confer voting rights upon the "control shares" at the next regularly scheduled shareholders meeting or at a special meeting. If the acquirer requests a special meeting and agrees to pay the associated expenses, target company management must hold the session within 50 days of the buyer's filing of an "acquiring person's statement." If the disinterested shareholders withhold voting rights, the target corporation may, but is not required to, redeem the control shares from the buyer.

Hence, the Indiana act effectively conditions a bidder's acquisition of corporate control on approval by a majority of shareholders, exclusive of the bidder and target management.

On March 10, 1986, Dynamics Corp. of America, which owned 9.6 percent of the outstanding common stock of CTS Corp., announced a tender offer for an additional one million CTS shares. The purchase would have increased Dynamics' ownership in CTS, an Indiana corporation, to 27.5 percent.

As part of its effort to frustrate Dynamics' tender offer, the CTS board on March 27, 1986, elected to become subject to the three-week old Indiana act. Eight days later, Dynamics alleged, in a complaint filed with the U.S. District Court for the Northern District of Illinois, that the federal Williams Act governing tender offers preempted the Indiana law and that the Indiana act violated the commerce clause of the U.S. Constitution. The court declared the Indiana act unconstitutional, and the Court of Appeals for the Seventh Circuit affirmed that decision.

By a vote of 6-3, the Supreme Court reversed the decision of the Seventh Circuit, holding that the Williams Act did not preempt the Indiana act. The Court concluded that:

- An offeror could comply with both the Williams

Act and the Indiana act; and

— The Indiana act furthers the purposes of the Williams Act by favoring neither management nor an offeror, but by protecting shareholders against the contending parties.

The court reasoned that a contrary holding would mean that the Williams Act preempted many other state corporate laws of previously unquestioned validity.

The Supreme Court also held that the Indiana act did not violate the commerce clause. The Court found that the Indiana law did not discriminate against or adversely affect interstate commerce because it:

- Equally affects all offerors, whether or not an Indiana domiciliary;

- Does not subject corporate activities to inconsistent regulation, since only Indiana law will govern the voting rights of corporations organized in that state; and

- Although potentially hindering some tender offers, regulates companies whose "very existence and attributes are products of state law."

The Supreme Court's decision apparently provided legislators with significant justification for using state corporation laws to help companies within their states that come under takeover attack.

The decision emphasized that every state had enacted laws regulating corporations within their respective borders and that each state has an interest in "promoting stable relationships among parties involved in the corporations it charters."

Hence, the *Dynamics* decision dramatically reaffirmed the "internal affairs doctrine," which asserts the primacy of state regulation of corporations generally and the voting rights of shareholders in particular. This landmark "state's rights" decision most assuredly invites several states to enact legislation similar to the Indiana act, and perhaps it encourages bolder legislatures to experiment with any other antitakeover law which the internal affairs doctrine can or might justify. If many states adopt new antitakeover statutes, the *Dynamics* decision could prove an important victory for companies seeking protection from hostile takeovers.³

In 1968, Virginia became the first state to adopt antitakeover legislation. By the late 1970s, approximately two-thirds of the states had enacted such laws.

Although varied, "first generation" statutes typically prohibited "nonexempt" stock purchases pursuant to tender offers, unless the offeror complied with specified disclosure and substantive requirements. These laws commonly gave a state regulatory agency the power to delay or prevent an offering that did not meet the statutory requirements.

The Supreme Court's invalidation of the Illinois Business Takeover Act in the *MITE* case effectively effaced first generation statutes. The Illinois act covered target companies of which Illinois shareholders owned at least 10 percent of the equity securities subject to the offer, or which met two of the following three conditions:

- The corporation had its principal executive office in Illinois;
- The corporation was organized under Illinois law; or
- The corporation had at least 10 percent of its stated capital and paid-in surplus within the state.

The offeror had to file a registration statement with the Illinois Secretary of State that could not become effective until 20 days after filing. During the waiting period, the secretary had the power to call a hearing to adjudicate the substantive fairness of the offering. If either a majority of the target's outside directors or Illinois shareholders holding at least 10 percent of the subject securities requested an administrative hearing, the hearing was mandatory.

The Supreme Court concluded that the Illinois act violated the commerce clause of the Constitution, because the statute imposed a direct restraint on interstate commerce as well as indirect burdens on interstate commerce that were not justified by the local interests which the statute allegedly furthered. Specifically, the Illinois act failed to withstand judicial scrutiny, because it interposed a state official in the process who could effectively frustrate a "hostile" tender offer and deprived target company shareholders of the right to decide whether to sell their shares.

Rushing into the breach

While placing the enforceability of other state antitakeover statutes in doubt, the *MITE* decision did create an opportunity for states to develop legislation that would pass the balancing test between legitimate local interests and the burdens on interstate commerce.

After *MITE*, courts invalidated the first generation statutes of, among other states, Missouri, Virginia, Michigan, Maryland, Nevada, New Jersey, and

Pennsylvania. In response to these developments, many state legislatures enacted "second generation" antitakeover statutes. These laws shifted the statutory emphasis from state regulatory intervention to the firm's internal affairs and operations.

Advancing to the "second generation"

Second generation statutes fall into three basic categories:

- Control share acquisition statutes;
- Dissenters' rights statutes; and
- Business combination/fair price statutes.

The control share acquisition statute, which the Indiana law exemplifies, typically requires shareholder approval of an acquisition of a specified threshold equity interest (usually beginning at 20 percent of the outstanding voting stock) pursuant to a tender offer, open market purchase, or private transaction. Joining Indiana in adopting this form of antitakeover law are Hawaii, Minnesota, Missouri, Wisconsin, North Carolina, and Ohio.

Under these statutes, the offeror's acquisition of stock and/or the ability to vote that stock must await disinterested shareholder approval at a special shareholders' meeting and thus could afford target management a tactical advantage — the breathing room to take a range of actions to fight off the raider even though the company still may be in play. These could include such responses as seeking a white knight with a higher bid, executing a management-led leveraged buyout, or launching a recapitalization/restructuring program to improve shareholder value.

Under dissenters' rights statutes, acquisition of a designated percentage (such as 20 percent of a corporation's capital stock) triggers dissenters' rights for the remaining shareholders who can demand payment of a "fair price" for their shares. To determine a fair price, any control premium paid for an offeror's earlier stock accumulation may be considered. Pennsylvania and Maine have such statutes.

Although the dissenters' rights statutes do not prevent the purchase of stock, the statutes discourage tender offers for less than 100 percent of a target's outstanding stock. Dissenters' rights laws presumably work against two-tier offers in which the back-end portion of the offer may be less valuable than the front end and also against cases in which a bidder is trying to minimize price by purchasing only enough shares to control the target.

In general, the business combination/fair price statutes prohibit mergers, purchases of substantially

all of the assets, consolidations and other business combinations between a corporation and an interested shareholder (typically defined as any 10 percent or 20 percent shareholder), unless:

— The board of directors recommends the combination; or

— Either a supermajority of shareholders approves the combination (sometimes only after a certain time period has passed) or the bidder pays a statutorily determined fair price.

States that have, or at one time did have, some version of this statutory scheme include Connecticut, Georgia, Illinois, Indiana, Kentucky, Louisiana, Maryland, Michigan, Mississippi, Missouri, New

York, Virginia, Washington, and Wisconsin.

The business combination/fair price statute does not directly hinder the tender offer, but applies when the interested shareholder wants to effect a second-step "business combination." Typically, these statutes also restrict the use of a target's assets to finance the acquisition.

An increasingly popular variation of, and an addition to, business combination statutes prohibits covered corporations from engaging in any business combination with any interested shareholder for some period (frequently, five years) following the date on which the "interested shareholder" became so classified. If these provisions apply, the parties

The Backlash on Stock Prices From State Takeover Laws

Studies by two government agencies have concluded that state antitakeover laws are costly to stockholder wealth. Based on stock market event studies linked to key developments in the progress of legislation in Ohio and New York, the results suggested losses running into the billions of dollars on share prices of companies based in the two states, at least over short periods of time.

A study by the Office of the Chief Economist of the Securities and Exchange Commission covered the impact of the new Ohio law that allows target company directors to consider long-range benefits in determining if their firm should stay independent. The event date is November 19, 1986, the day the bill was passed by the state Senate, one day before it was approved by the House, and three days before it was signed into law by Gov. Richard Celeste.

According to a market-model approach, the abnormal decline in shares of 36 Ohio companies was 0.73 percent on November 19th. Including Goodyear Corp., which then was resisting a takeover by Sir James Goldsmith, the fall was 0.90 percent. For a three-day window from November 18-20, the drop was 1.68 percent for the 36 basic stocks and 1.84 percent with Goodyear included. During a 10-day window which began November 10 when talk of a new antitakeover law first circulated, the fall was 3.24 percent for the 36-stock sample and 3.4 percent when Goodyear was added.

Results were similar in a companion net-of-market analysis, under which the Standard & Poor's 500-stock index movement, used as a proxy for the entire market, was subtracted from the movement of Ohio stocks. The abnormal declines were: November 19, 0.89 percent for 36 Ohio stocks and 1.05 percent with Goodyear included; November 18-20, 1.68 percent for 36 stocks and 1.79 percent with Goodyear included; and November 10-20, 3.2 percent for 36 stocks and 3.35 percent with Goodyear added.

Based on the market-model results, the SEC economist's office estimated the declines at \$754 million for the November 18-20 period and \$1.45 billion for November 10-20.

The New York study was conducted by Lawrence Schumann of the Federal Trade Commission's Bureau of Economics and covered a series of three-day windows surrounding developments in the state's antitakeover law in 1985. The most important were Gov. Mario Cuomo's veto of the first version of the law on August 13 and his espousal of a new proposal on October 30.

Applying market-model methodology to a sample of 94 companies, Schumann found that shares posted an abnormal gain of 0.76 percent during the period surrounding the Cuomo veto. But when the governor announced his own bill, there was an abnormal drop of 0.97 percent, estimated at nearly \$1.2 billion.

M&A

can avoid the "business combination moratorium" only if the target company's board approved the business combination prior to the date on which the interested shareholder was so designated. Kentucky adopted this form of antitakeover measure coincident with the Belzberg family's unsolicited bid for Ashland Oil Corp. in 1986.

Pennsylvania. The Pennsylvania antitakeover statute can be classified as a dissenters' rights law. When an acquirer purchases more than 30 percent of the stock of certain Pennsylvania corporations, the buyer becomes a "controlling person" and must notify all shareholders of record. Each shareholder then may decide whether to demand cash equal to the fair value of his shares as of the day before the exact date the acquirer became a "controlling person," taking into account all relevant factors, including any control premiums that were paid. This antitakeover defense, sometimes referred to as a "shareholder put provision," applies to all Pennsylvania corporations that have securities registered under the Securities and Exchange Act of 1934, unless shareholders amend the articles of incorporation to exempt the company.

This landmark "state's rights" decision most assuredly invites several states to enact legislation similar to the Indiana act, and perhaps it encourages bolder state legislatures to experiment.

The Pennsylvania statute also allows directors and officers of a state-chartered corporation to consider factors other than economic benefit to shareholders in deciding whether to recommend or oppose a tender offer.

California. A bill introduced in the California legislature in June 1987, resembles the Indiana control share acquisition law. One major difference is that it applies not only to California-chartered companies, but concerns that are incorporated outside the state yet have at least 50 percent of their shareholders, property, payroll, and sales within California. This would extend the state's antitakeover provisions to the large number of companies that do most of their business in California but are incorporated in Delaware.

Delaware. In a surprise move, Delaware decided not to go ahead with Indiana-style legislation after the Corporate Law Section of the Delaware Bar Association recommended against it. Historically, Delaware has been quick to amend its corporation

laws to attract more incorporations when judicial opinions, laws, or business trends offered it the opportunity to become a haven against the adverse consequences of those developments. For example, Delaware, in the wake of several damage suits against corporate directors in the mid-1980s, changed its laws in 1986 to restrict director and management liability for companies chartered in the state. However, the Delaware legislature balked when those responsible for drafting antitakeover legislation expressed serious doubts that control share statutes or other antitakeover measures are effective. The chairman of the Corporate Law Section of the Delaware Bar also noted that Congressional action could nullify such state legislation.

In view of the recent Supreme Court decision indicating a new judicial tolerance for antitakeover statutes, however, many state legislatures may seize the opportunity to enact laws similar to the Indiana act or other forms of antitakeover provisions and thereby demonstrate their support for incumbent managements and "local" employees.

North Carolina, for example, quickly responded to the plight of "native" Burlington Industries Inc., target of a hostile offer by investor Asher Edelman and Dominion Textile Co., by adopting a statute in May 1987 patterned after Indiana's. Meanwhile, Minnesota swiftly added a business combination statute to its antitakeover law arsenal in June 1987 when Dayton Hudson Corp. apparently was being threatened by Dart Group Corp.

Nevertheless, state legislators should react cautiously to the Supreme Court's initial approval of state efforts to discourage "hostile" takeovers of "state treasures." Each antitakeover statute which varies from the Indiana act must be examined closely in light of the *MITE* and *Dynamics* decisions for any constitutional weakness. Furthermore, even if a state adopts a statute identical to the Indiana act, the political and economic consequences of such an action may not be wholly beneficial. ■

Endnotes

1 *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. ___, 107 S.Ct. 1637, 95 L.Ed. 2d 67 (1987).

2 *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

3 In addition to the Indiana Control Share Acquisition Act, now of unquestioned validity, Indiana also has in effect an antitakeover statute which restricts certain business combinations with persons deemed to be "interested shareholders." Indiana Business Corporation Law, Ind. Code §§ 23-1-43-1 et. seq.

4 *Fleet Aerospace Corp. v. Holderman*, 637 F.Supp. 742 (SD Ohio 1986) *aff'd* 796 F.2d 135 (6th Cir. 1986).

INTERVIEWING AND ADVISING
THE SECURITIES CLIENT

Cynthia W. Young
Wyatt, Tarrant and Combs
Louisville, Kentucky

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SECTION F



INTERVIEWING AND ADVISING
THE SECURITIES CLIENT

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Cynthia W. Young
Wyatt, Tarrant & Combs
Louisville, Kentucky

INTERVIEWING AND ADVISING
THE SECURITIES CLIENT

I. Conflicts of Interest

A. Between the Issuer and members of management

1. Necessity of disclosing wrongdoing (or even evidence of bad judgment) by or claims against officers or directors of the Issuer to potential investors
2. When the attorney is a director or officer

B. Between the Issuer and existing shareholders

1. Fixing the price and/or terms of a securities offering; dilution

C. Between the Issuer and Underwriter

1. Escott v. Bar Chris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) noted independent role of Underwriter in registration process
2. Pricing of the securities offered
3. Disclosure obligations
4. Shifting responsibilities by contract: representations and warranties, indemnity and formulas for contribution
 - [a] Use of legal opinions from issuer's counsel, certificates of officers of issuer
 - [b] Note position of SEC with respect to indemnification for securities law violations and undertaking required under Item 512 of Regulation S-K

- II. Engagement letters and retainers
 - A. Scope of representation
 - 1. Securities laws (federal and states)
 - 2. Structure of transaction - registration versus exemption from registration under state and federal securities laws
 - 3. Other laws which may impact transaction (for example banking laws, tax considerations)
 - B. Use of retainers to avoid appearance of financial interest in offering
- III. Due Diligence by the Client
 - A. The purpose of due diligence is to avoid liability under the securities laws
 - 1. Certain liabilities imposed on issuers or sellers under the Securities Act of 1933 (the 1933 Act) are "absolute," in that they are not based on scienter.
 - [a] An issuer is liable under Section 12(1) of the 1933 Act if it sells, using the jurisdictional means, a security without registration or an available exemption.
 - [b] An issuer is liable under Section 11 if its registration statement, at the time it becomes effective, contains an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading (unless the purchaser knew of the untruth or omission).
 - 2. Other liabilities imposed by the 1933 Act, especially liabilities imposed on controlling persons or, in the case of registered offerings, on directors, chief executive and financial officers,

experts and underwriters, are not "absolute;" a due diligence defense exists.

- [a] Section 12(2) imposes liability on a person who offers or sells a security, using the jurisdictional means, by means of a prospectus or oral communication which contains an untrue statement of material fact or omits a material fact necessary to make the statements in the light of the circumstances under which they are made not misleading (provided the purchaser does not know of the untruth or omission). A defense exists if the person proves he did not know, and, in the exercise of reasonable care, could not have known, of the untruth.

The Sixth Circuit has defined a "seller" for purposes of Section 12 to include persons whose acts are a substantial factor in bringing about the sale if, but for such acts, the sale would not have occurred. Davis v. Avco Financial Services, Inc., 739 F.2d 1057 (6th Cir. 1984), cert. denied, 470 U.S. 1005 and 472 U.S. 1012.

- [b] Each director, chief executive or financial officer, expert and underwriter is liable under Section 11 for material misstatements or omissions in a registration statement unless he can prove:

- [i] as to the nonexpertised portions of the registration statement, that he had, after reasonable investigation, reasonable ground to believe and did believe, at the time the registration statement became effective, that the statements were true and there was no omission;

[ii] with respect to any part of the registration statement purporting to be made on the authority of an expert (other than himself) or to be a statement made by a public official document, he had no reasonable ground to believe, and did not believe, at the time the registration statement became effective, that the statements were untrue or omitted to state a material fact required to be stated or necessary to make the statements made not misleading or that such part did not fairly represent the statement of the expert or public official or was not a fair copy or extract from his report or official public document; or

[iii] if an expert, with respect to any part of the registration statement purported to be made on his authority, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time the registration statement became effective, that the statements were true and there was no omission or that the registration statement did not fairly present his statement or contain an accurate copy of his report.

[c] Section 15 of the 1933 Act imposes liability on persons controlling any person liable under Sections 11 or 12 unless the controlling person had no knowledge of the facts giving rise to the liability and no reasonable grounds to believe of such facts.

[d] The courts will impose liability for aiding and abetting a securities violation if there exists an

independent securities law violation, the person knowingly and substantially assisted the conduct constituting the violation, and knew or was aware that his role was a part of an activity that was improper or illegal. SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975). SEC v. Falstaff Brewing Corp., 629 F.2d 62, 72 (D.C. Cir.), cert. denied, 449 U.S. 1012 (1980).

[e] Section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act) and Rule 10b-5 promulgated thereunder give rise to a private cause of action if there is fraud in connection with the purchase or sale of a security.

B. What constitutes a reasonable investigation and reasonable belief for purposes of establishing the due diligence defense:

1. Section 11(c) of the 1933 Act defines reasonable investigation and a reasonable ground for belief on the basis of the "reasonableness ... required of a prudent man in the management of his own property."
2. Rule 179 promulgated under the 1933 Act lists 8 factors relevant to a determination of the reasonableness of an investigation or ground for belief: the type of issuer and security offered; the office, if any, held with the issuer; status as an inside or outside director; reasonable reliance on insiders who should have known of the particular facts; in the case of an underwriter, the underwriting arrangement, its role and the information available; and, in the case of a document incorporated by reference, the person responsible for preparing it.

[a] See also, Feit v. Leasco Data Processing Equipment, 332 F. Supp. 544, 577-578 (E.D.N.Y. 1971)

(noting reasonableness may be affected by degree of involvement, expertise and access).

3. In Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980), cert. denied, 450 U.S. 1005 (1981), the court looked to the reasonable investigation required under Section 11 when analyzing whether underwriter exercised the reasonable care required under Section 12(2) of the 1933 Act.

C. Determining the expertised portions of a registration statement:

1. Those parts prepared on the basis of the expert's report

[a] An expert's consent is required if his report is quoted or summarized in a registration statement. Rule 436 of Regulation C under the 1933 Act.

2. Compare reliance on expert's advice in carrying out due diligence obligations.

IV. Due diligence by counsel:

A. Basis for liability:

1. Attorney who also serves as a director and/or officer of the issuer is subject to the rules of liability discussed above

[a] The Bar Chris court noted that the role of an outside director in preparing a registration statement as issuer's counsel increased his duty of investigation for carrying out his due diligence obligation under Section 11.

2. Attorney involved in preparation of disclosure document has a duty of due diligence and reasonable inquiry.

[a] Failure to exercise due diligence could result in an injunctive

action by the SEC under Section 20 of the 1933 Act or a suspension or disbarment action by the SEC under Rule 2(e) of the Rules of Practice (17 C.F.R. §201.2(e)).

[b] If failure to exercise due diligence relates to "expertised" portion of registration statement prepared by counsel, such failure could result in liability under Section 11 of the 1933 Act.

[i] The Bar Chris court noted fact that attorney was primarily responsible for preparation of registration statement does not make entire registration statement "expertised" by him.

[ii] Opinion of attorney (such as valid issuance of security, tax consequences) probably would constitute part of disclosure document for which attorney must exercise due diligence

[c] SEC v. Frank, 388 F.2d 486 (2nd Cir. 1986): attorney drafting disclosure document could not close his eyes to readily apparent misleading statements.

[d] Felts v. National Account Systems Associations, Inc., 469 F. Supp. 54 (N.D. Miss. 1978): duty of lawyer to make reasonable investigation and correct false and misleading statements.

3. Duty to disclose

[a] Attorney may be liable for aiding and abetting a securities law violation if aware of client's nondisclosure

[i] See Section III.A.2.d. (page 4) for elements of aiding and abetting

[ii] Contexts in which duty to disclose may arise:

(a) In preparation of disclosure document, at time registration statement becomes effective, at closing

See, SEC v. National Student Marketing Corp., 457 F. Supp. 682 (D.D.C. 1978)

(b) In future transactions - disclosure of past wrongdoing, potential liabilities

(c) In day to day representation - timely disclosure of material events

[iii] Imputed knowledge: knowledge of facts by other attorneys in firm which are not known by attorney preparing disclosure document. In re Keating, Muething & Klekamp (1979 Transfer Binder) Fed. Sec. L. Rptr. (CCH) ¶82,124 (1979).

[b] Ethical considerations

[i] General prohibition on disclosure of client confidences

[ii] Necessity of withdrawal -

Section 11 permits a person (other than an issuer) to avoid liability for misleading statements or omissions in a registration statement if he resigns or withdraws and provides written notice to issuer and SEC.

[c] Moore, et al. v. Fenex Incorporated, et al., 809 F.2d 297 (6th Cir. 1987), cert. denied, 107 S.Ct. 3231 (1987): attorney was not liable when he required client to comply with the representations in offering circular upon learning of noncompliance, rather than requiring revision of offering circular

Initial Offering Checklist

- I. Terms of offering
 - A. Use of proceeds; reasons for offering; necessity of future offerings
 - B. Plan of distribution
 - 1. Availability of an exemption from registration under federal law - intrastate offering
 - 2. States involved
 - [a] Necessity of registering issuer as a broker or dealer
 - 3. Underwriting arrangements
 - [a] Firm versus best efforts underwriting - note the effect a broad "market-out" condition in underwriting agreement may have on a firm underwriting
 - [b] All or none, minimum-maximum offerings
- II. Advising the Issuer:
 - A. Review with officers and directors their role in registration process; encourage active participation
 - B. Distribution of drafts of disclosure documents with management as prepared; distribution of final draft to management, accountants, all Board members
 - C. Attendance at special meeting of Board of Directors reviewing in detail disclosure document and adopting authorizing resolutions
 - D. Obtain certificates from appropriate members of management as to matters of fact

III. Due Diligence - Preparation of Disclosure Document

A. Organization and good standing of issuer

1. Certified copies of articles of incorporation and all amendments
 - [a] confirm adoption of amendments by requisite Board and shareholder vote; compliance with notice requirements in KRS 271A.295
 - [b] note super-majority or anti-takeover provisions
 - [c] consider statutes in effect at time
2. Organizational minutes of issuer: election of officers, adoption of bylaws, stock certificates, bank resolutions
3. Review of minutes, confirming annual election of required number of directors and officers (president, secretary and treasurer are required by KRS 271A.250)
4. Review of Bylaws and amendments, noting requirements as to numbers of directors, notice of meetings
5. List of states where the issuer transacts business and is (or should be) qualified
6. Good Standing Certificates

B. Capitalization and Shareholders

1. Compare number of authorized, issued and outstanding shares of capital stock
 - [a] Check Board (or, if articles provide, shareholder) minutes for authorization of share issuances and sales and receipt of required consideration
 - [b] Check Articles of Incorporation for existence of preemptive rights

- [c] Review of stock records; cross check list of shareholders with stock certificate book
 - [d] Consider outstanding warrants, options and convertible securities; sufficiency of number of authorized shares
2. Determine beneficial share ownership by affiliates; names and addresses of 5% shareholders, directors and officers
 3. Review stock purchase agreements, voting trust agreements, shareholders' or stock restriction agreements
 4. Triggering of any repurchase or registration rights of existing shareholders
 5. Review employee stock ownership plans, stock bonus or other agreements to issue shares
 6. Review certificates representing shares to determine if they are in the proper form and bear all required legends (restrictions under applicable securities laws or agreements, notice of other classes or series of stock)
 7. Check compliance with securities laws for prior stock issuances or sales, and the disclosure materials used
 - [a] Consider possible integration of prior offerings
 8. Review dividends paid and trading prices of stock during the past 2 years
 - [a] Note recent transactions by the issuer, its affiliates or employee stock plans could give rise to claims of market manipulation and/or trading on inside information
 - [i] Rule 10b-18 provides a safe-harbor rule from the anti-

fraud statutes for certain purchases by issuers, its affiliates and affiliated purchasers

C. Financial condition, financial statements and quality

1. Review five years consolidated and consolidating statements, and any exceptions noted, and most recent unaudited statements, with comparable statements for prior year
2. Review auditors' letters to management, auditors' inquiry letters and replies for five years
3. Review budgets and projections with management and accountants
4. Meeting with accountants who prepared financials; determine whether there have been any disputes or changes in accounting procedures
5. Confirm filing of tax returns, existence of consolidated tax agreements, IRS audits, extensions for filings or waivers of statute of limitations
6. Management's Discussion and Analysis of Financial Condition and Results of Operations
 - [a] Should address, at a minimum, liquidity, capital resources and results of operations, describing trends, commitments or uncertainties and explaining changes reflected in the financial statements over the past three years and any interim period
 - [b] Interview officers
7. Note risks attendant to specific operations, market conditions, material changes since date of financial statements, probable transactions which would be material to issuer

D. Business of the Issuer

1. Development of business since organization; business done and intended to be done; and any bankruptcy, or similar proceedings, mergers, acquisitions or dispositions of assets in which the issuer or its affiliates has been involved or which is proposed
2. Industry segments, geographic areas and their performance; reliance (or dependence) on principal products, sources, markets or customers.
3. Compliance with laws, regulatory and environmental.
 - [a] Determine applicable statutes, rules and regulations
 - [b] Terms or conditions of any required licenses
 - [c] Review material license agreements, permits or governmental consents and regulatory filings for the past five years
 - [d] Pending or proposed legislation which could materially affect issuer's business or financial reporting
4. Terms of material contracts (duration, obligations imposed, uncured defaults, necessity of waivers of consents)
 - [a] Consider necessity of contacting lenders, reviewing correspondence with material suppliers, customers
5. Competitive conditions, identifying markets, competitors and competitive position
 - [a] Condition of the industry in general, issuer's standing in the industry

6. Number of employees, reliance on key employees, labor disputes

E. Management

1. Director and Officer Questionnaires eliciting, among other things, names, addresses, ages, and stock ownership, business experience during the past 5 years of each officer and director and dates during which any position was held with the issuer or any affiliate

[a] Prior wrongdoing, criminal convictions or bankruptcy proceedings of officers and directors.

[b] Disputes surrounding the termination, resignation or removal of any director or officer

2. Compensation of directors and officers

[a] Cash compensation and perquisites

[b] Employee benefit plans and actuarial reports (ERISA compliance and adequate funding)

[c] Employee stock ownership and bonus plans (price, compliance with securities and corporate laws)

[d] Employment agreements, change in control, golden parachute, indemnification and noncompete provisions

[e] Union agreements

[f] Labor disputes; OSHA, EEOC and related matters

[g] Workers' compensation, fidelity or blanket bond coverage

F. Properties: ownership, location, condition and insurance coverage

1. Review title reports and insurance policies

2. Conduct UCC and judgment searches
- G. Legal proceedings
1. Obtain a complete list of pending litigation, review recent responses to auditor's inquiry, contact local counsel, registered agent
 2. Consider threatened or potential litigation
- H. Any other matter material to an investment decision
- IV. Conduct During Offering - Anti-fraud rules of the Securities Exchange Act of 1934 (the 1934 Act)
- A. Consider sending a black-out memorandum to officers and directors to cease all trading immediately prior to announcement of public offering
 - B. Rule 10b-6 generally prohibits issuers, underwriters, participating brokers or dealers and affiliated purchasers from purchasing a security while participating in a public distribution, other than as part of the distribution
 - C. Rule 10b-7 limits stabilizing the price of a security during a distribution
 - D. Rule 10b-8 identifies certain manipulative or fraudulent practices in the context of a rights offering
 - E. Rule 10b-9 prohibits certain representations in connection with an offering where no firm underwriting is in place
- V. Conduct After Offering Registered Under the 1933 Act
- A. Filing of Form SR reporting sales of securities pursuant to Rule 463 of Regulation C promulgated under the 1933 Act
 - B. Post effective amendment deregistering securities not sold

C. Continuing reporting obligations under the 1934 Act

1. Section 15(d) imposes ongoing reporting requirements the year in which the registration statement becomes effective and each year thereafter during which [a] the issuer has at least 300 shareholders of record and [b] the issuer's security is not registered pursuant to Section 12 of the 1934 Act
2. Registration under Section 12 is required if the security is held by at least 500 shareholders and the issuer has more than \$1,000,000 in assets
3. Distribution to shareholders of earnings statement covering 12 months beginning after effective date of registration statement increases burden of proof under Section 11 of the 1933 Act in action by someone who purchases after such distribution

February 12, 1988

FORM OF QUESTIONNAIRE FOR OFFICERS AND DIRECTORS

This Questionnaire is being sent to the officers and directors of _____ (the "Company") to obtain information to be used in connection with the preparation of a disclosure statement in connection with the offering of as many as _____ shares of the Company's _____. For purposes of this Questionnaire, [i] the last fiscal year of the Company means the period beginning on _____, and ending on _____, and [ii] Subsidiaries means _____.

Please answer all questions fully. If the answer to any question is "None" or "Not applicable," please so state. If the space provided for an answer is not adequate, please answer the question in an attachment to the Questionnaire and refer to the attachment in the space provided. Please complete, sign, date and return one copy of this Questionnaire to _____ by _____. The extra copy is for your file.

Question 1. Personal Information.

- [a] State your name as it should appear in the disclosure document.

ANSWER:

- [b] State your address and date of birth.

ANSWER:

- [c] List all positions and offices with the Company and the Subsidiaries you have held and now hold and the dates you first took, and periods during which you held, such positions or offices.

ANSWER:

- [d] Describe any arrangement or understanding (written or otherwise) between you and any other person pursuant to which you were selected as a director or executive officer of the Company or the Subsidiaries. Do not include arrangements or understandings with directors or officers of the Company or the Subsidiaries acting solely in their capacities as such.

ANSWER:

- [e] Describe any family relationship between you and any other director officer or person nominated or chosen to become a director or officer of the Company or the Subsidiaries. The term "family relationship" means any relationship by blood, marriage or adoption not more remote than first cousin. The term "officer" means any official who performs policy making functions for the Company.

ANSWER:

- [f] Describe briefly your business experience during the past five (5) years, including your principal occupations and employment during that period and the name and principal business of any corporation or other organization in which such occupations and employment were carried on. Include employment with the Company or the Subsidiaries. What is required is information relating to the level of your professional experience.

ANSWER:

- [g] If you are a director of any corporation (other than the Company) required to file reports with the Securities and Exchange Commission or registered under the Investment Company Act of 1940, list below the name of each such corporation.

ANSWER:

- [h] If the answer to any of the following questions is "yes," please provide complete details of the events, including the dates the events occurred and any mitigating factors.

ANSWER:

- [1] Has a petition under the Bankruptcy Act or any state insolvency law ever been filed by or against, or a receiver, fiscal agent or similar officer been appointed by a court for the business or property of [i] you, [ii] any

partnership in which you were, or within two (2) years before the time of such filing had been, a general partner or [iii] any corporation or business association of which you were, or within two (2) years before the time of such filing had been, a director or an executive officer?

ANSWER:

- [2] Have you ever been convicted in a criminal proceeding or are you now a named subject in a pending criminal proceeding (excluding traffic violations or other minor offenses)?

ANSWER:

- [3] Have you ever been the subject of any order, judgment or decree, not subsequently reversed, suspended or vacated, of any court of competent jurisdiction or of any federal or state authority permanently or temporarily enjoining, barring, suspending or otherwise limiting your right to engage in or be associated with persons engaged in the following activities:

- [i] Acting as an investment advisor, underwriter, broker or dealer in securities, or as an affiliated person, director or employee of any investment company, bank, savings and loan association or insurance company, or engaging in or continuing any conduct or practice in connection with such activity?

ANSWER:

- [ii] Engaging in any type of business practice?

ANSWER:

- [iii] Engaging in any activity in connection with the purchase or sale of any security or in connection with any violation of federal or state securities laws?

ANSWER:

- [4] Have you even been found by a court of competent jurisdiction in a civil action or by the Securities and Exchange Commission to have violated any federal or state securities law, and the judgment in such civil action or finding by the S.E.C. has not been subsequently reversed, suspended or vacated?

ANSWER:

Question 2. Business Relationships.

If the answer to any of these questions is "yes," please provide details of the relationship.

- [a] At any time since _____, have you been an officer, director or employee of, or have you owned, directly or indirectly, in excess of one percent (1%) equity interest in any Company?

- [1] Which as made payments to the Company or the Subsidiaries for property or services during the Company's last full fiscal year in excess of \$ _____?

ANSWER:

- [2] Which proposes to make payments to the Company or the Subsidiaries for property or services during the current fiscal year in excess of \$ _____?

ANSWER:

- [3] To which the Company or the Subsidiaries was indebted at any time since the beginning of the Company's last fiscal year in an aggregate amount in excess of \$ _____?

ANSWER:

- [4] To which the Company or the Subsidiaries has made payments for property or services during

such entity's last fiscal year in excess of \$_____?

ANSWER:

[5] To which the Company or the Subsidiaries proposes to make payments for property or services during such entity's current fiscal year in excess of \$_____?

ANSWER:

[b] Are you a member or employee of, or associated with, a law firm which the Company has retained at any time since _____, or which the Company proposes to retain in the current fiscal year?

ANSWER:

[c] Are you a director, partner, officer, or employee of any investment banking firm which has performed services for the Company (other than as a participating underwriter in a syndicate) at any time since _____, or which the Company proposes to have perform services in the current fiscal year?

ANSWER:

[d] Describe any other business or personal relationships with the Company or its management which are substantially similar in nature and scope to those relationships listed in parts [a] and [c] of this question.

ANSWER:

Question 3. Holdings of Common Stock of the Company.

This question concerns the amount of Common Stock of the Company beneficially owned. directly or indirectly, by you. The term "beneficial ownership" includes not only securities held by you for your own benefit (whether in bearer form or registered in your name or otherwise, and whether owned solely by you or jointly with someone else),

but also securities held by others for your benefit (regardless of record ownership), e.g., securities held for you by custodians, brokers, relatives, trustees, executors, or administrators, securities held for your account by pledges, securities owned by a partnership of which you are a member, and securities owned by a corporation which should be regarded as a personal holding company of yours. Securities recently purchased by you and awaiting transfer into your name should be included. Beneficial ownership does not include securities held by you in a fiduciary capacity, or otherwise for the benefit of another person of a security.

- [a] Indicate the number of shares of Common Stock of the Company as to which you are a beneficial owner as defined above.

ANSWER:

- [1] Of the amount listed in [a], indicate the number of shares as to which you have sole investment and sole voting powers.

ANSWER:

Describe the nature of your ownership of any shares included in your response to [a] as to which you do not have sole voting and sole investment powers. Indicate any shares as to which you disclaim beneficial ownership.

ANSWER:

- [b] Indicate the number of additional shares of Common Stock as to which you have a right to acquire beneficial ownership as defined above, at any time, including but not limited to any right to acquire: [i] through the exercise of any option, warrant or right; [ii] through the conversion of a security; [iii] pursuant to the power to revoke a trust, discretionary account or similar arrangement; or [iv] pursuant to the automatic termination of a trust, discretionary account or similar arrangement.

ANSWER:

Question 4. Identity of Group.

Describe and identify the members of any group known to you to be the beneficial owner or more than five percent (5%) of the Common Stock of the Company. For this purpose, the term "group" means two or more persons who act or agree to act as a partnership, limited partnership, syndicate or other group for the purposes of acquiring, holding,, voting or disposing of securities. See Question 3 for the definition of the term "beneficial ownership."

ANSWER:

Question 5. Remuneration.

- [a] If you or any associate of yours acquired during the Company's last fiscal year, or you or an associate of yours expects to acquire during the Company's current fiscal year, any property or securities under any contract, agreement, plan, or arrangement (other than pursuant to an option or warrant plan) from the Company or the Subsidiaries, furnish details of the transaction including the spread between the acquisition price and the fair market price of any such property or securities determined as of the acquisition date or the date your right to the property or securities became unconditionally vested, whichever is later. The term "associate" means [a] any corporation or organization, other than the Company or the Subsidiaries, of which at the time of the transaction you were an officer or partner or of which at the time of the transaction you were, directly or indirectly, the beneficial owner of ten percent (10%) or more of any class of equity securities, [b] any trust or estate in which at the time of the transaction you had a substantial beneficial interest or as to which at the time of the transaction you served as trustee or in a similar capacity, [c] any relative or spouse of yours, or any relative of your spouse. who at the time of the transaction either had the same home as you or who was a director or officer of the Company or the Subsidiaries. See Question 3 for the definition of the term "beneficial ownership."

ANSWER:

[b] Describe in detail any unreimbursed personal benefits, such as those listed below, that were not directly related to your job performance, furnished to you or any associate of yours, by the Company or the Subsidiaries directly or through a third party, during the Company's last fiscal year. You need not furnish information regarding benefits which were provided to broad categories of employees and which do not discriminate in favor of officers or directors.

[1] The personal use of automobiles, airplanes, apartments, etc. owned or leased by The Company or the Subsidiaries;

ANSWER:

[2] Repairs, improvements or service to home, automobile or other personal property;

ANSWER:

[3] Personal travel, entertainment, housing, or other ordinary living expenses or club membership fees paid for by the Company or the Subsidiaries:

ANSWER:

[4] Personal legal, accounting, financial planning or other professional services provided by personnel of the Company or the Subsidiaries, paid for by the Company or the Subsidiaries or for which the Company or the Subsidiaries otherwise gave compensation; or

ANSWER:

[5] The purchase of goods or services on a bargain basis.

ANSWER:

[6] Personal loans from the Company or the Subsidiaries at favorable terms or interest rates.

ANSWER:

[7] Arrangements involving personal loans from other banks.

ANSWER:

If any of the foregoing related to personal and business purposes, indicate the approximate percentage attributable to each such purpose. See Question 5[a] for the definition of the term "associate."

ANSWER:

Question 6. Options.

Please complete the following table with respect to options granted to you for the purchase of Common Stock of the Company.

[a] Options granted to you during the Company's last fiscal year:

<u>Number of Shares</u>	<u>Option Price per Share</u>	<u>Date Granted</u>
-------------------------	-------------------------------	---------------------

[b] Options exercised by you during the Company's last fiscal year:

<u>Number of Shares</u>	<u>Aggregate Purchase Price</u>	<u>Date of Purchase</u>	<u>Aggregate Market Price on Date of Purchase</u>
-------------------------	---------------------------------	-------------------------	---

[c] Unexercised options currently held by you:

<u>Number of Shares</u>	<u>Average Option Price Per Share</u>
-------------------------	---------------------------------------

Question 7. Material Transactions.

Describe in detail any transaction or series of transactions since the beginning of the Company's last fiscal year, or any proposed transaction, to which the Company or the Subsidiaries was or will be a party, in which you or any associate of yours had or will have a direct or indirect interest. Include information regarding any transaction entered into by the Company or the Subsidiaries and a third party where the primary purpose of the transaction as to furnish remuneration to you. These transactions include loans to or from the Company or the Subsidiaries, guarantees by the Company or the Subsidiaries of any obligation of yours or any associate of yours, guarantees by you of any obligation of the Company or the Subsidiaries, purchases of property from or sales or leases to the Company or the Subsidiaries. See Question 5[a] for the definition of the term "associate."

ANSWER:

Question 8. Indebtedness to the Company or the Subsidiaries.

If you are, or any associate of yours is, or if you were, or any associate of yours was, at any time since the beginning of the Company's last fiscal year indebted to the Company or the Subsidiaries in any amount, state the largest aggregate amount of indebtedness at any time during such period, the nature of the indebtedness and of the transaction in which it was incurred, the amount of the indebtedness at the present time, and the rate of interest and any other material terms of the loan such as maturity, amortization, schedule and security. See Question 5[a] for the definition of the term "associate."

ANSWER:

Question 9. Changes in Control of the Company.

Describe any arrangements known to you, including, any pledge of stock of the Company, the operation of which may at a subsequent date result in a change in control of the Company.

ANSWER:

Question 10. Legal Proceedings.

Describe briefly any interest adverse to the Company or the Subsidiaries which you or any associate of yours has in any pending legal proceeding. See Question 5[a] for the definition of the term "associate."

ANSWER:

Question 11. Transactions with Pension or Similar Plans.

Describe in detail any transactions since the beginning of the Company's last fiscal year or any presently proposed transactions to which any pension, retirement, savings or similar plan provided by the Company or the Subsidiaries was or is to be a party, in which you or any associate of yours had or has a direct or indirect interest. Include any remuneration received or any loans received proposed to be received, or outstanding during the period. Information need not be furnished with respect to payments to the plan or payments to the beneficiaries, pursuant to the terms of the plan. The term "plan" includes all plans, contracts, authorizations or arrangements, whether or not set forth in any formal documents. See Question 5[a] for the definition of the term "associate."

ANSWER:

The answers to the foregoing questions are correctly stated to the best of the knowledge, information and belief of the undersigned. The undersigned will promptly notify the Company of any changes in the foregoing information which may occur prior to the completion date of the offering.

Dated: _____

Signature

COMMON SECURITIES LAW PROBLEMS
FACED BY
CLOSELY HELD BUSINESSES

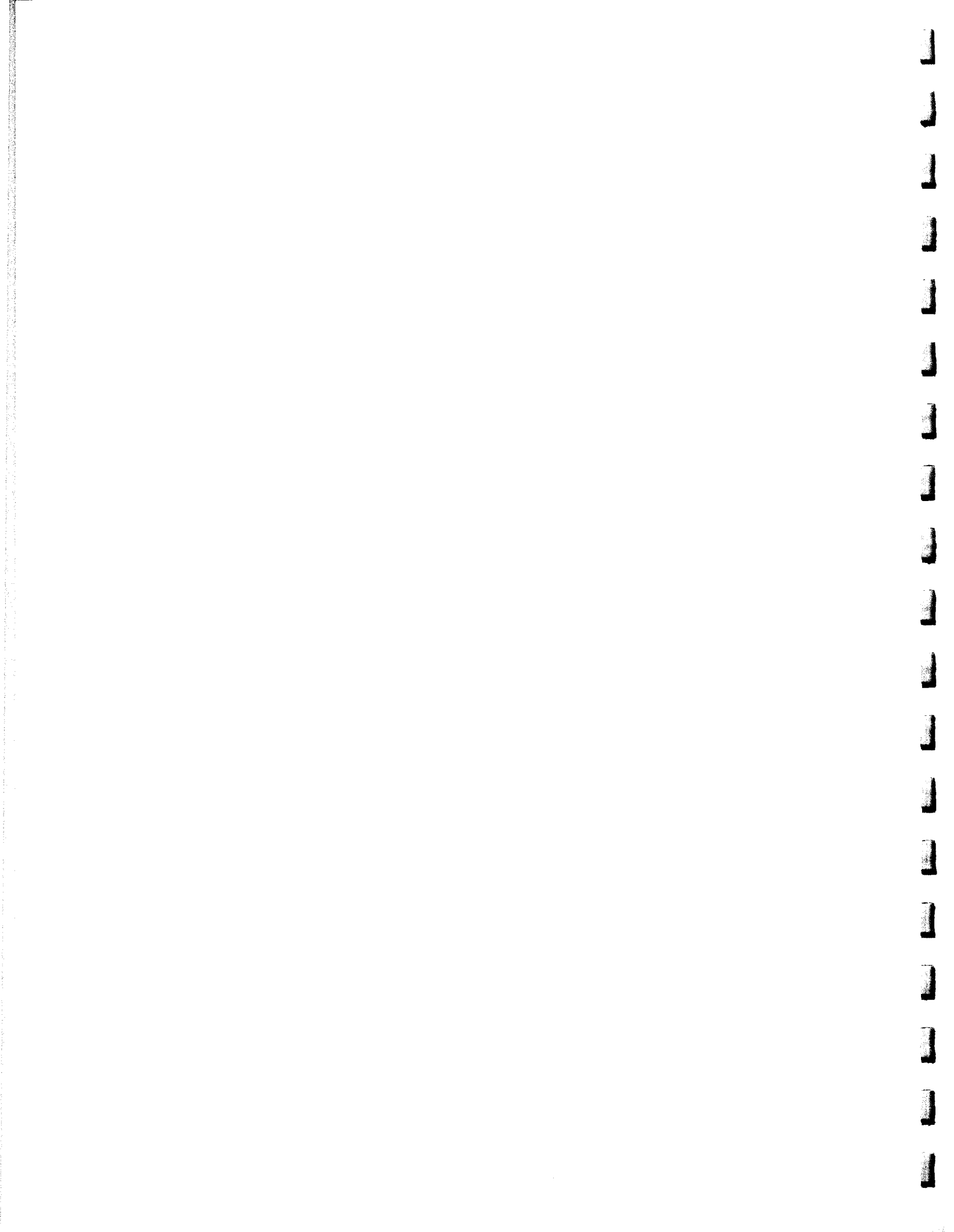
Presented by

George W. Vieth
and
Kenneth R. Sagan

Stites & Harbison
Louisville, Kentucky

No Outline Submitted

SECTION G



REGULATION D

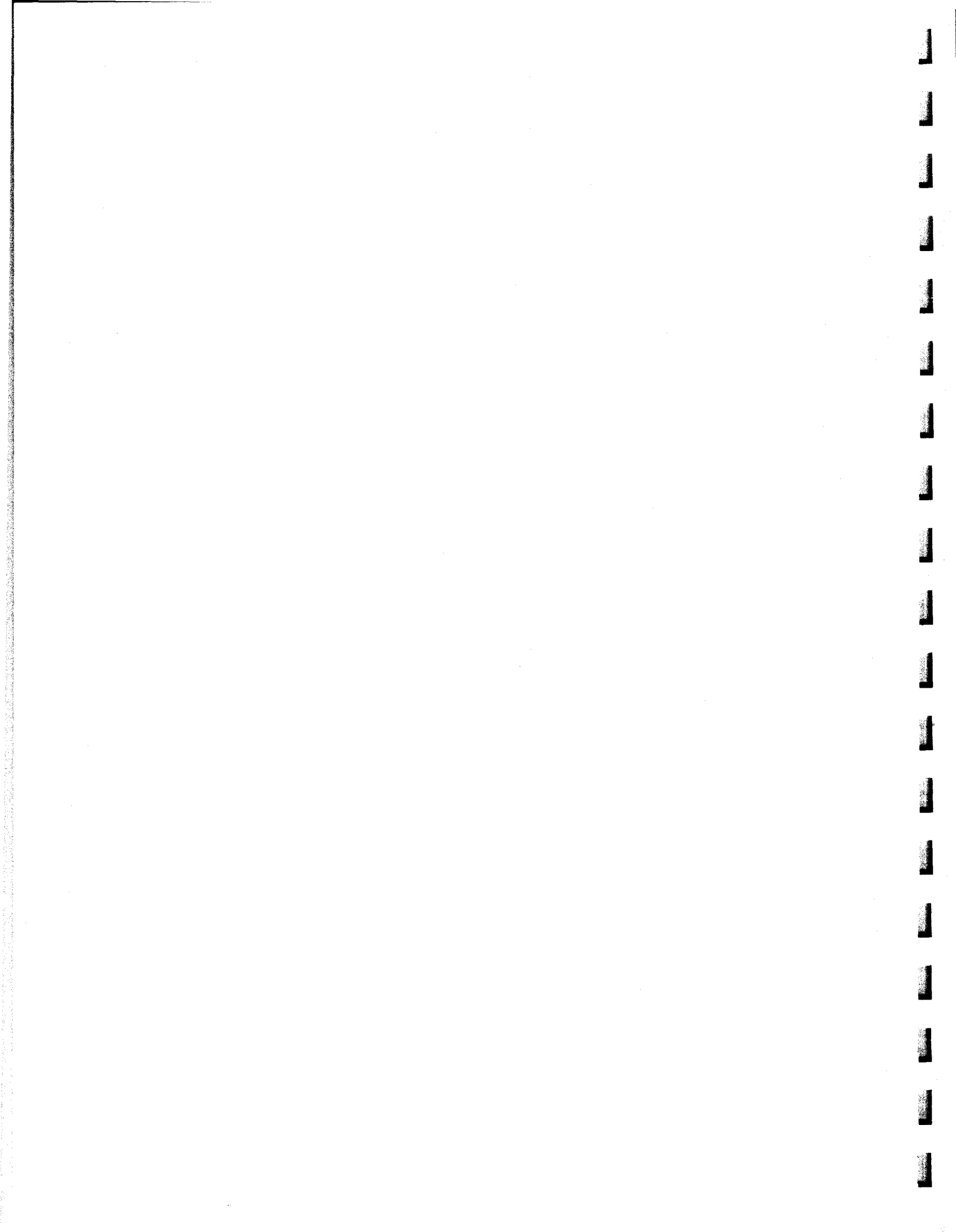
THE SOMETIMES UNAVAILABLE OR
IMPRACTICAL SAFE HARBOR:

THE SECTION 4(2) ALTERNATIVE

David W. Harper
and
Charles E. Scholtz
Hirn, Reed, Harper and Eisinger
Louisville, Kentucky

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and
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SECTION H

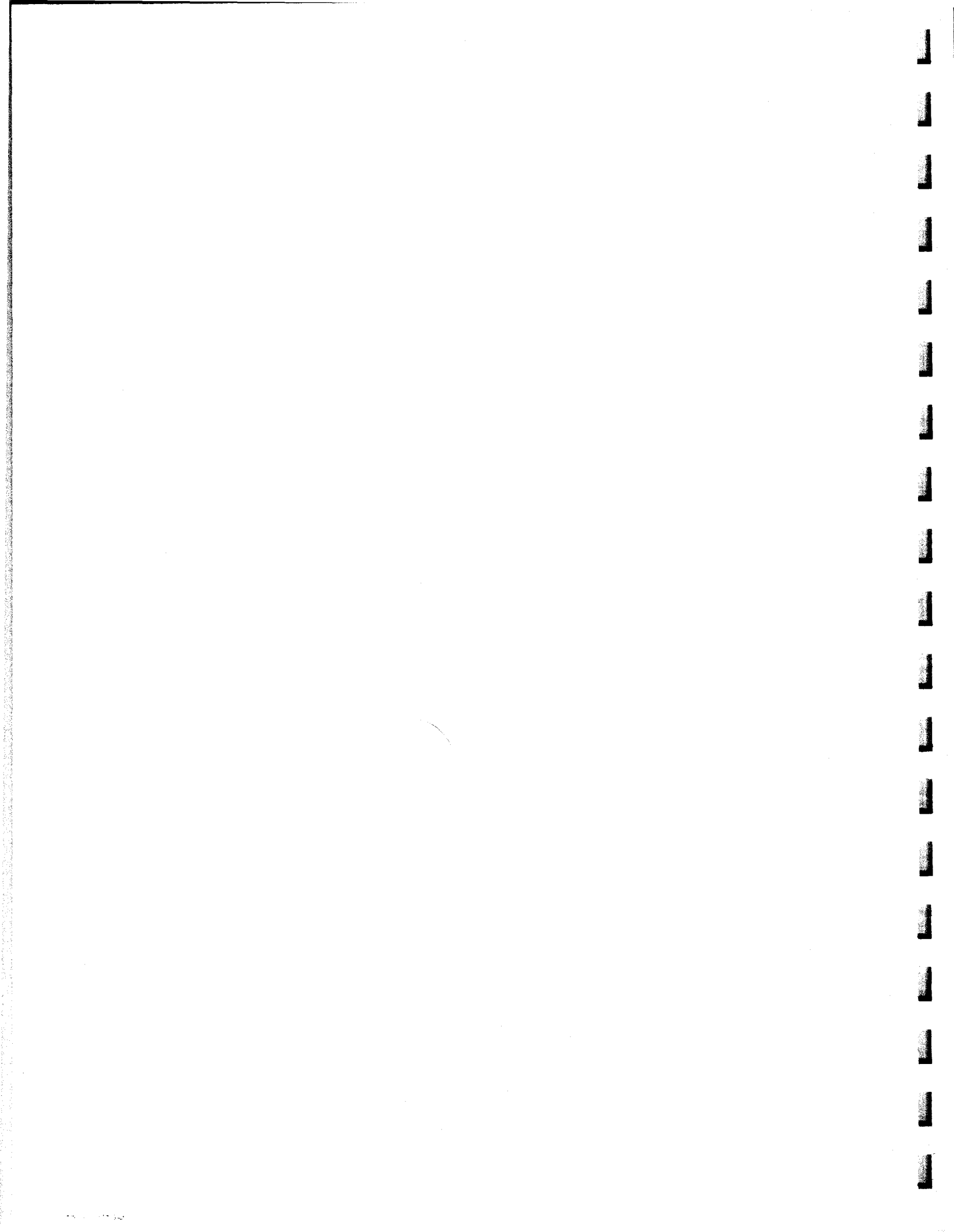


REGULATION D -

THE SOMETIMES UNAVAILABLE OR IMPRACTICAL SAFE HARBOR:
THE SECTION 4(2) ALTERNATIVE

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**REGULATION D - THE SOMETIMES UNAVAILABLE OR IMPRACTICAL
SAFE HARBOR: THE SECTION 4(2) ALTERNATIVE**

I. Introduction

Section 5 of the 1933 Securities Act (the "Act") forbids the offer or sale of unregistered securities in interstate commerce. This prohibition is the primary means of effecting the Act's purpose, which is to protect investors by a "full and fair disclosure in connection with the offer and sale of securities".

Regulation D is the product of an evaluation by the Securities and Exchange Commission (the "Commission") of the impact of its rules and regulations on the ability of small businesses to raise capital. Registration of securities is an expensive undertaking and the Commission's evaluation revealed a concern that the registration requirements and the exemptive scheme of the Act imposed disproportionate restraints (largely economic in nature) on small issuers. Regulation D provides exemptions from the registration requirements for offerings (i) up to \$500,000, (ii) up to \$5 million, and (iii) without any limitation as to amount. The first two exemptions were promulgated under Section 3(b) of the Act and the third under Section 4(2); these sections operate to relieve an issuer from the registration requirement where registration is deemed unnecessary.

- * Section 3(b), 15 U.S.C. §77c(b), is not self-executing and provides that the Commission may enact rules and regulations which exempt securities (as opposed to transactions) from the registration requirement in offerings of up to \$5 million if it finds that registration "is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering"
- * Section 4(2), 15 U.S.C. §77d(2), the so-called "private offering" exemption, provides that no registration is required for transactions (as opposed to securities) by an issuer not involving any public offering. An exemption under Section 4(2) may be self-executing and its availability depends upon the relevant administrative and

judicial interpretations in effect at the time of the transaction.

The purpose of this outline is to consider the possibility of the issuer not qualifying for an exemption under Regulation D and then to examine, as an alternative, the common law exemption available under the arguably "larger" exemption afforded by Section 4(2). The Commission's promulgation of Regulation D has been of extreme help and use to many businesses seeking to raise capital. However, it is not quite the panacea the Commission suggests where start-up or small businesses are involved. Much about Regulation D has been directed to the general practitioner's attention. There has been less of a focus on the considerations in doing a "private placement" where Regulation D is unavailable or impractical to use as an exemption from registration.

To this end, it is necessary to first examine the rules which constitute Regulation D, with particular focus on those provisions which may pose problems for the small issuer in particular. With these rules (and their purposes) in mind, it is useful to then examine more thoroughly the Section 4(2) exemption and the body of case law which has developed thereunder.

An extensive review of Regulation D is beyond the scope of this outline and the reader is urged to read the regulation (17 C.F.R. §§230.501-506 (1984)) and the Commission's only interpretive release thereon (Securities Act Release No. 33-6455 (March 3, 1983), 1 Fed. Sec. L. Rep. (CCH) ¶2380). A copy of the regulation is attached as Appendix I. Also recommended are the following articles: Campbell, "The Plight of Small Issuers (and Others) under Regulation D: Those Nagging Problems That Need Attention", 74 Ky.L.J. 127 (1985-86); Sparks, "Regulation D: Financing Opportunities for Small Businesses", University of Kentucky/Continuing Legal Education: Sixth Annual Seminar on Securities Law, February 13-14, 1987.

II. Summary of Regulation D

Regulation D consists of seven Preliminary Notes followed by Rules 501 through 506 of the Act. Rules 501 through 503 set forth definitions, terms and conditions that apply generally to the entire

regulation. Rules 504, 505 and 506 each provide an exemption to the registration requirement. The applicability of any one exemption depends upon the characteristics of the particular offering.

A. Preliminary Notes

Several of the Preliminary Notes to the regulation and the concepts they embody are of particular importance in the context of this outline as they should be considered in the context of a Section 4(2) exemption as well as an exemption under Regulation D.

- (i) For purposes of this outline, the third Preliminary Note is perhaps the most significant. It reminds the issuer that attempted compliance with Regulation D does not constitute an election and the issuer can also claim the availability of any other applicable exemption. For instance, an issuer's failure to satisfy all the terms and conditions of Rule 506 does not necessarily preclude the availability of an exemption under Section 4(2); the same may be said for Regulation D offerings which fail for other reasons, such as the issuer's failure to comply with the notice requirement of Rule 503 or an offering which involves an amount in excess of an exemption's prescribed limits.
- (ii) The first Preliminary Note reminds the issuer that Regulation D only exempts transactions from the registration requirements of Section 5 of the Act and not from the antifraud or civil liability provisions of the federal securities laws. The issuer must always provide such further material information (in addition to that information which may be specifically required to be disclosed under an exemption - see Rule 502(b), discussed in section II, C(ii), infra) as is necessary to make any information furnished, in light of the circumstances under which it is furnished, not misleading. This requirement is of critical importance and should always be considered, for as a practical matter, it may necessitate extensive disclosure of information despite the absence of specific

disclosure requirements (such as may be the case under a Rule 504 or 506 exemption). This same disclosure principle applies when an exemption is sought under Section 4(2).

- (iii) Nothing in Regulation D (or Section 4(2) for that matter) preempts any state law and issuers are reminded of the necessity to comply with applicable state securities laws regarding the offer and sale of securities, including any variations from Regulation D in states that have adopted a limited offering exemption based on Regulation D. See, e.g., KRS Chapter 292 and 808 KAR Chapter 10.
- (iv) The exemptions under Regulation D are available only to the issuer of the securities and not to any affiliate of that issuer or to any other person for resales of the issuer's securities. With certain exceptions under Rule 504, Regulation D provides an exemption only for the transactions in which the securities are offered or sold by the issuer, not for the "restricted securities" themselves. Therefore, under Regulation D, there is no distinction between the exemption available under Section 3(b) of the Act (which relates to exempt securities) and that under Section 4(2) of the Act (which relates to exempt transactions).
- (v) Preliminary Note 6 reminds the issuer that Regulation D is not available to any issuer for any transaction, although in technical compliance with its rules, which is part of a plan or scheme to evade the registration requirements of the Act.

B. Rule 501

Rule 501 of Regulation D contains certain definitions applicable throughout the entire regulation, the most significant of which, from the issuer's standpoint, is "accredited investor" for the following reasons: (i) accredited investors are excluded in calculating the number of purchasers under the "35 purchaser limitation" of Rules 505 and 506; (ii) if accredited investors are the only purchasers under Rules 505 and 506, no specific

disclosure is required by Rule 502(b); and (iii) in offerings under Rule 506 only investors who are not accredited are required to meet the "sophistication" requirement.

An accredited investor is any person who falls within (or whom the issuer reasonably believes falls within) any one of eight specified categories of investors, which include, among others, those persons who are insiders (i.e., directors, executive officers and general partners) of the issuer or who are of significant financial means and therefore better able to bear the economic risk of the investment. As will be discussed later in section IV, infra, the general concepts embodied within the definition of accredited investors are pertinent in a Section 4(2) analysis as they relate generally to the notions of an investor who can "fend for himself" and therefore does not need the protection provided by the Act.

C. Rule 502

Rule 502 provides general conditions applicable to all offers and sales under Regulation D. The concepts embodied in Rule 502 (integration, information requirements, limitation on manner of offering and limitations on resale) are largely applicable in the context of a Section 4(2) exemption and generally constitute a critical part of the common law established thereunder. (See section IV, infra.)

- (i) Integration. All sales that are part of the same Regulation D offering must be integrated. There will be no integration for all offers and sales that take place at least six months before the start or six months after the termination of a Regulation D offering, so long as there are no offers and sales within either of these six month periods. With regard to exemptions under Regulation D (and also for Section 4(2) purposes), the following factors should be considered in determining whether offers and sales should be integrated:
- (a) Whether the sales are a part of a single plan of financing;

- (b) Whether the sales involve issuance of the same class of securities;
 - (c) Whether the sales have been made at or about the same time;
 - (d) Whether the same type of consideration is received; and
 - (e) Whether the sales are made for the same general purpose.
- (ii) Information Requirements. The information required to be disclosed generally depends upon the exception utilized, the size of the offering and whether or not the issuer is a reporting company:
- (a) If an issuer sells securities under Rule 504 or only to accredited investors, no specific disclosure is required.
 - (b) Nonreporting companies must furnish the same kind of information required by Part I of Form S-18 (or the other appropriate registration form depending on the type and size of the transaction). At a minimum, this disclosure includes two years' financial statements, the most recent of which should be audited. If audited financial statements cannot be obtained without unreasonable effort or expense (accounting fees incurred to have an audit performed are generally not regarded by staff at the Commission as a sufficient reason to avoid full audited financial statements), then certain issuers may file instead an audited balance sheet dated within 120 days of the offering. As a practical matter, this disclosure requirement of Regulation D may pose problems for small issuers as they often do not have a formal presentation of this information; in addition, such presentations may be (i) cost prohibitive in view of the size of the offering, or (ii) impossible to prepare within the short time frame in which small issuers must often operate

to take advantage of sudden business opportunities.

(c) A reporting company can meet the disclosure requirements (regardless of the size of the offering) by providing its annual reports, proxy statements and periodic reports filed with the Commission pursuant to the Securities Exchange Act of 1934.

(iii) Limitation on Manner of Offering. General solicitation or general advertising in connection with a Regulation D (and Section 4(2)) offering is generally prohibited.

(iv) Limitations on Resale. With certain exceptions under Rule 504, securities issued in Regulation D offerings are "restricted securities" and the issuer must exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of Section 2(11) of the Act, which reasonable care should include inquiry as to investment purpose, the disclosure of resale limitations and the placement of a legend on the certificate identifying it as a "restricted security". Likewise, an exemption under Section 4(2) does not apply to any subsequent dispositions of the securities -- in fact, the exemption's availability depends in part on the issuer's taking these same precautionary measures in order to assure that the securities are not subsequently offered or sold in violation of federal securities laws.

D. Rule 503

Rule 503 sets forth the filing requirements with regard to Form D (a uniform notice of sales form) for use in offerings under Regulation D, which must be filed within 15 days after the first sale.

E. The Exemptions: Rules 504-506

(i) Rule 504. Rule 504 provides an exemption pursuant to Section 3(b) of the Act for

offerings up to \$500,000 in a 12-month period by an issuer who is not a reporting company or an investment company. There are no purchaser qualifications, disclosure requirements or limitations on the number of purchasers. Under certain conditions, there may be a general solicitation and the securities may be resold without any restrictions.

(ii) Rule 505. Rule 505 provides an exemption pursuant to Section 3(b) of the Act for offerings up to \$5 million in a 12-month period by an issuer which is not an investment company. No general solicitation is allowed and there may be no more than 35 purchasers, excluding accredited investors. The exemption is not allowed if the issuer or its affiliates or any underwriter being used or any affiliate of the underwriter was the subject of certain administrative, civil or criminal actions (the "bad boy" provisions).

(iii) Rule 506. Rule 506 provides an exemption pursuant to Section 4(2) of the Act for offerings without regard to the dollar amount. There can be no general solicitation and sales may be made only to accredited investors and up to 35 sophisticated persons.

III. Exemption under Section 4(2) when Regulation D is Unavailable

Despite the flexibility and certainty which an exemption under Regulation D affords and the extent to which it facilitates capital formation opportunities for small businesses, there remain certain situations where an exemption under Regulation D would not be available, albeit for seemingly insignificant reasons. It is therefore useful to consider the availability of the exemption provided by Section 4(2). Consider the following situations:

- (i) Ex: An issuer loses its exemption under Regulation D for "technical noncompliance", for example, it fails to timely file its Form D notice or it sells to 36 sophisticated (but not "accredited") investors; or

- (ii) Ex: An issuer needs to raise \$750,000 in a short period of time in order to be able to take advantage of a tremendous business opportunity. The issuer, managed and owned by two honest, hardworking brothers with a "great business idea", can account for every penny received and spent but have always avoided an audit and the accompanying expense. An audit of their company and the preparation of only an audited balance sheet still will take three months, at which point the business opportunity will no longer exist.

In considering possible reliance on the Section 4(2) exemption, the issuer is reminded that (i) in an action for violation of the requirements of the securities laws, the issuer bears the burden of demonstrating the affirmative defense of the exemption, (ii) the exemption is generally strictly construed, and (iii) the antifraud and civil liability provisions are always applicable.

IV. Administrative and Judicial Interpretation of Section 4(2)

A. Background

- (i) The Ralston Purina Case. The seminal case dealing with the "private offering" analysis is Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119, 73 S.Ct. 981, 97 L.Ed. 1494 (1953). Here, the Supreme Court considered whether Ralston Purina's offering of stock to hundreds of its "key employees" (including various foremen and clerical assistants) was a public offering. In addressing the question of what constitutes a public offering, the Court first stated that an offer need not be open to the whole world to be public. It provided further that ". . . the applicability of [Section 4(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'." The Court held that the company's offering to "key employees" did not fall within the exemption because the employees "were not shown to have access to

the kind of information which registration would disclose." Ralston Purina, 346 U.S. at 123-127, 73 S.Ct. at 983-985.

- (ii) Securities Act Release No. 33-285. Section 4(2) of the Act was first addressed by the Commission in Release No. 33-285 (1 Fed. Sec. L. Rep. (CCH) ¶2740-44 (January 24, 1935)), which discussed generally certain factors in determining the availability of the exemption. These included the number of offerees and their relationship to each other and the issuer, and the size and manner of the offering.

These factors serve as guideposts, and the fact that one factor weighs heavily in favor of the private status of an offering is not sufficient to ensure availability of the exemption. Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1973). Over the years, the courts have expanded upon these factors (with slight variations) and they remain as the basic framework in which Section 4(2) judicial analyses continue to operate; not surprisingly, such an analysis has substantial "overlap" with the conceptual framework of Regulation D as the exemptions provided by both are meant to serve the same purpose: to provide an exemption to the registration requirements where registration is deemed unnecessary.

B. Section 4(2) Analysis

- (i) Number of Offerees. The number of offerees, not the number of purchasers, is the relevant figure in considering the number of persons involved in an offering. Doran, 545 F.2d at 900 (offering of limited partnership interests in oil drilling venture to eight offerees). While the number of offerees is not itself decisive, "the more offerees, the more likelihood that the offering is public." Securities and Exchange Commission v. Murphy, 626 F.2d 633, 645 (9th Cir. 1980) (\$7.5 million offering of limited partnership interests involving 400 investors not exempt). In addition, the issuer should know the exact number and identity of every offeree. Western Federal Corporation v. Erickson, 739

F.2d 1439, 1442 (9th Cir. 1984) (sale of interests in a silver mining venture to 66 investors was not exempt). Also relevant here is the consideration of the integration principle (see section II, C(i), infra) in determining whether apparently separate "private" offerings should be integrated into one de facto "public" offering. Murphy, 626 F.2d at 645.

- (ii) Size and Manner of Offering. The size and manner of the offering are generally considered closely in connection with the number of offerees. The offering should be made through a direct communication to a sufficiently select group of qualified offerees or their representatives. All forms of general advertising and mass media circulation should be avoided -- helpful in this regard is the practice of numbering the offering memoranda and monitoring their whereabouts. If an offering is small and is made directly to the offerees rather than through the facilities of public distribution, it will more likely be found to be private. Murphy, 626 F.2d at 646.

Additionally, the issuer should take certain measures to ensure the securities are not subsequently redistributed in violation of federal securities laws; these precautions include (i) legending the certificates and disclosing the resale restrictions (ii) receiving an investment (non-distribution) letter from the purchaser and (iii) issuing the securities in relatively large denominations (see section II, C(iv), infra).

- (iii) Sophistication of Offerees. The offeree's level of sophistication is relevant in determining his ability to "fend for himself". There are varying degrees of sophistication but even a high degree of offeree sophistication does not supplant the necessity of the offeree having access to the information that registration would disclose, as there must always be a sufficient basis of accurate information upon which the sophisticated

investor may exercise his skills. Doran, 545 F.2d at 902-903.

Two factors are of particular importance in evaluating an offeree's sophistication. The issuer should have reasonable grounds to believe (after due inquiry) that the offeree (i) is capable of understanding and evaluating the merits and risks of the proposed investment or (ii) is of sufficient financial means so that he can bear the economic risk of the investment. Securities Act Release No. 33-5487 (April 23, 1974), 1 Fed. Sec. L. Rep. (CCH) ¶2710.

- (iv) Relationship between the Issuer and the Offerees. The exemption from registration requirements allowed by Section 4(2) applies where only the offerees do not need the protection of the Act. "Lack of need exists only if all of the offerees have available the sort of information about the issuer that registration reveals . . . Such information is 'available' only if it is in fact disclosed or if the offerees have effective access to it." Western, 739 F.2d at 1443.

As a practical matter, an issuer often may not be able to rely on actual disclosure, as such disclosure would necessitate the preparation of an extensive disclosure memorandum containing that information which registration would disclose. Such a compilation may be (i) cost prohibitive to the issuer in light of the size of the offering, or (ii) impossible to prepare within the short period of time in which such issuers often must operate. Therefore, the issuer often must look to satisfying the disclosure of information requirement by providing the offeree "effective access" to such information, an alternative which may not be available under a Regulation D offering.

When the issuer relies on access absent actual disclosure, he must show that the offerees occupied a privileged position relative to the issuer that afforded them an opportunity for effective access to the

information registration would otherwise provide. That is, there must be 'a relationship based on factors such as employment, family, or economic bargaining power that enables the offeree effectively to obtain such information.'

Western, 739 F.2d at 1443, citing Doran. Moreover, the presence of one of these factors will not satisfy the information requirement if, in spite of that factor's presence, the reality of the situation is that the offeree still does not have effective access to that information which registration would disclose. For example, see Leiter v. Kuntz, et al., 655 F.Supp. 725 (Utah, 1987) where an offeree, who actively operated the business of the issuer prior to his purchase of issuer's stock, did not necessarily have access to the required information.

In this regard, the relationship between the offeree and issuer is of critical importance. Likewise, the investment sophistication of the offeree assumes increased significance, "for it is important that he could have been expected to ask the right questions and seek out the relevant information" so that he may properly evaluate the investment risk. Doran, 545 F.2d at 905.

V. Conclusion

Generally, an offering may be exempt under Section 4(2) of the Act if (i) the number of offerees and the size and manner of the offering are such that they do not constitute a public offering, (ii) each offeree receives or otherwise has access to extensive information concerning the issuer, and (iii) each offeree has a sufficient combination of sophistication (so that he may properly evaluate the information) and financial means (so that he may bear the economic risk of the investment). Likewise, by quantifying the common law factors developed under Section 4(2), Regulation D has been successful in providing a similar exemption. In view of the clarity and comfort it affords, Regulation D is clearly the preferable exemption where its requirements can be met from a technical and practical standpoint.

However, because small businesses, as a practical matter, do not always consult counsel before raising capital, are often under time constraints in their effort to do so and often do not have audited financial statements and other well-documented records pertaining to their businesses, there do arise those situations where an exemption under Regulation D is not available and an exemption under Section 4(2) must be considered. Regulation D and Section 4(2) are intrinsically related, and while Section 4(2) utilizes the same general factors considered in a Regulation D analysis, the absence of specific disclosure and investor-related criteria in Section 4(2) (which are present in Regulation D and may operate to preclude its availability) may sometimes provide a claim for an exemption from registration when Regulation D does not.

APPENDIX I

§ 230.501

REGULATION D—RULES GOVERNING THE LIMITED OFFER AND SALE OF SECURITIES WITHOUT REGISTRATION UNDER THE SECURITIES ACT OF 1933

AUTHORITY: Sections 230.501 to 230.506 issued under secs. 3(b), 4(2), 19(a), 19(c), 48 Stat. 75, 77, 85; sec. 209, 48 Stat. 908; c.122, 59 Stat. 167; sec. 12, 78 Stat. 580; 84 Stat. 1480; sec. 308(a)(2), 90 Stat. 57; sec. 18, 92 Stat. 275; sec. 2, 92 Stat. 962; secs. 505, 622, 701, 94 Stat. 2291, 2292, 2294 15 U.S.C. 77c(b), 77d(2), 77s(a), 77s(c).

SOURCE: Sections 230.501 to 230.506 appear at 47 FR 11262, Mar. 16, 1982, unless otherwise noted.

PRELIMINARY NOTES

1. The following rules relate to transactions exempted from the registration requirements of section 5 of the Securities Act of 1933 (the "Act") (15 U.S.C. 77a *et seq.*, as amended). Such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. Issuers are reminded of their obligation to provide such further material information, if any, as may be necessary to make the information required under this regulation, in light of the circumstances under which it is furnished, not misleading.

2. Nothing in these rules obviates the need to comply with any applicable state law relating to the offer and sale of securities. Regulation D is intended to be a basic element in a uniform system of Federal-State limited offering exemptions consistent with the provisions of sections 18 and 19(c) of the Act. In those states that have adopted Regulation D, or any version of Regulation D, special attention should be directed to the applicable state laws and regulations, in-

cluding those relating to registration of person who receive remuneration in connection with the offer and sale of securities, to disqualification of issuers and other persons associated with offerings based on state administrative orders or judgments, and to requirements for filings of notices of sales.

3. Attempted compliance with any rule in Regulation D does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption. For instance, an issuer's failure to satisfy all the terms and conditions of Rule 506 shall not raise any presumption that the exemption provided by section 4(2) of the Act is not available.

4. These rules are available only to the issuer of the securities and not to any affiliate of that issuer or to any other person for resales of the issuer's securities. The rules provide an exemption only for the transactions in which the securities are offered or sold by the issuer, not for the securities themselves.

5. These rules may be used for business combinations that involve sales by virtue of rule 145(a) (17 CFR 230.145(a)) or otherwise.

6. In view of the objectives of these rules and the policies underlying the Act, regulation D is not available to any issuer for any transaction or chain of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration under the Act is required.

7. Offers and sales of securities to foreign persons made outside the United States effected in a manner that will result in the securities coming to rest abroad generally need not be registered under the Act. See Release No. 33-4708 (July 9, 1964) [29 FR 828]. This interpretation may be relied on for such offers and sales even if coincident offers and sales are made under Regulation D inside the United States. Thus, for example, persons who are not citizens or residents of the United States would not be counted in the calculation of the number of purchasers. Similarly, proceeds from sales to foreign purchasers would not be included in the aggregate offering price. The provisions of this note, however, do not apply if the issuer elects to rely solely on Regulation D for offers or sales to foreign persons.

[47 FR 11262, Mar. 16, 1982, as amended at 47 FR 54771, Dec. 6, 1982]

§ 230.501 Definitions and terms used in Regulation D.

As used in Regulation D (§§ 230.501—230.506), the following

terms shall have the meaning indicated:

(a) *Accredited investor*. "Accredited investor" shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in section 3(a)(2) of the Act whether acting in its individual or fiduciary capacity; insurance company as defined in section 2(13) of the Act; investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; Small Business Investment Company licensed by the U.S. Small Business Administration under section 301 (c) or (d) of the Small Business Investment Act of 1958; employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of \$5,000,000;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any organization described in section 501(c)(3) of the Internal Revenue Code with total assets in excess of \$5,000,000;

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(5) Any person who purchases at least \$150,000 of the securities being offered, where the purchaser's total purchase price does not exceed 20 percent of the purchaser's net worth at the time of sale, or joint net worth with that person's spouse, for one or any combination of the following: (i) Cash, (ii) securities for which market quotations are readily available, (iii) an unconditional obligation to pay cash or securities for which market quotations are readily available which

obligation is to be discharged within five years of the sale of the securities to the purchaser, or (iv) the cancellation of any indebtedness owed by the issuer to the purchaser;

(6) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;

(7) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years and who reasonably expects an income in excess of \$200,000 in the current year; and

(8) Any entity in which all of the equity owners are accredited investors under paragraphs (a) (1), (2), (3), (4), (6), or (7) of this section.

(b) *Affiliate*. An "affiliate" of, or person "affiliated" with, a specified person shall mean a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.

(c) *Aggregate offering price*. "Aggregate offering price" shall mean the sum of all cash, services, property, notes, cancellation of debt, or other consideration received by an issuer for issuance of its securities. Where securities are being offered for both cash and non-cash consideration, the aggregate offering price shall be based on the price at which the securities are offered for cash. If securities are not offered for cash, the aggregate offering price shall be based on the value of the consideration as established by bona fide sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard.

(d) *Business combination*. "Business combination" shall mean any transaction of the type specified in paragraph (a) of Rule 145 under the Act (17 CFR 230.145) and any transaction involving the acquisition by one issuer, in exchange for all or a part of its own or its parent's stock, of stock of another issuer if, immediately after the acquisition, the acquiring issuer has control of the other issuer (whether or not it had control before the acquisition).

(e) *Calculation of number of purchasers*. For purposes of calculating

the number of purchasers under §§ 230.505(b) and 230.506(b) only, the following shall apply:

(1) The following purchasers shall be excluded:

(i) Any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser;

(ii) Any trust or estate in which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(iii) of this section collectively have more than 50 percent of the beneficial interest (excluding contingent interests);

(iii) Any corporation or other organization of which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(ii) of this section collectively are beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests; and

(iv) Any accredited investor.

(2) A corporation, partnership or other entity shall be counted as one purchaser. If, however, that entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor under paragraph (a)(8) of this section, then each beneficial owner of equity securities or equity interests in the entity shall count as a separate purchaser for all provisions of Regulation D (§§ 230.501—230.506).

NOTE: The issuer must satisfy all the other provisions of Regulation D for all purchasers whether or not they are included in calculating the number of purchasers. Clients of an investment adviser or customers of a broker or dealer shall be considered the "purchasers" under Regulation D regardless of the amount of discretion given to the investment adviser or broker or dealer to act on behalf of the client or customer.

(f) *Executive officer.* "Executive officer" shall mean the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer. Executive officers of subsidiaries may be deemed executive officers of the issuer if they

perform such policy making functions for the issuer.

(g) *Issuer.* The definition of the term "issuer" in section 2(4) of the Act shall apply, except that in the case of a proceeding under the Federal Bankruptcy Code (11 U.S.C. 101 *et seq.*), the trustee or debtor in possession shall be considered the issuer in an offering under a plan or reorganization, if the securities are to be issued under the plan.

(h) *Purchaser representative.* "Purchaser representative" shall mean any person who satisfies all of the following conditions or who the issuer reasonably believes satisfies all of the following conditions:

(1) Is not an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer, except where the purchaser is:

(i) A relative of the purchaser representative by blood, marriage or adoption and not more remote than a first cousin;

(ii) A trust or estate in which the purchaser representative and any persons related to him as specified in paragraph (h)(1)(i) or (h)(1)(iii) of this section collectively have more than 50 percent of the beneficial interest (excluding contingent interest) or of which the purchaser representative serves as trustee, executor, or in any similar capacity; or

(iii) A corporation or other organization of which the purchaser representative and any persons related to him as specified in paragraph (h)(1)(i) or (h)(1)(ii) of this section collectively are the beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests;

(2) Has such knowledge and experience in financial and business matters that he is capable of evaluating, alone, or together with other purchaser representatives of the purchaser, or together with the purchaser, the merits and risks of the prospective investment;

(3) Is acknowledged by the purchaser in writing, during the course of the transaction, to be his purchaser representative in connection with evaluat-

ing the merits and risks of the prospective investment; and

(4) Discloses to the purchaser in writing prior to the acknowledgment specified in paragraph (h)(3) of this section any material relationship between himself or his affiliates and the issuer or its affiliates that then exists, that is mutually understood to be contemplated, or that has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.

NOTE 1: A person acting as a purchaser representative should consider the applicability of the registration and antifraud provisions relating to brokers and dealers under the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S.C. 78a *et seq.*, as amended) and relating to investment advisers under the Investment Advisers Act of 1940.

NOTE 2: The acknowledgment required by paragraph (h)(3) and the disclosure required by paragraph (h)(4) of this section must be made with specific reference to each prospective investment. Advance blanket acknowledgment, such as for "all securities transactions" or "all private placements," is not sufficient.

NOTE 3: Disclosure of any material relationships between the purchaser representative or his affiliates and the issuer or its affiliates does not relieve the purchaser representative of his obligation to act in the interest of the purchaser.

§ 230.502 General conditions to be met.

The following conditions shall be applicable to offers and sales made under Regulation D (§§ 230.501—230.506):

(a) *Integration.* All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in rule 405 under the Act (17 CFR 230.405).

NOTE: The term "offering" is not defined in the Act or in Regulation D. If the issuer offers or sells securities for which the safe harbor rule in paragraph (a) of this § 230.502 is unavailable, the determination as to whether separate sales of securities are part of the same offering (i.e. are considered "integrated") depends on the particular facts and circumstances. Generally, transactions otherwise meeting the requirements of an exemption will not be integrated with simultaneous offerings being made outside the United States effected in a manner that will result in the securities coming to rest abroad. See Release No. 33-4708 (July 9, 1964) [29 FR 828].

The following factors should be considered in determining whether offers and sales should be integrated for purposes of the exemptions under Regulation D:

- (a) Whether the sales are part of a single plan of financing;
- (b) Whether the sales involve issuance of the same class of securities;
- (c) Whether the sales have been made at or about the same time;
- (d) Whether the same type of consideration is received; and
- (e) Whether the sales are made for the same general purpose. See Release No. 33-4552 (November 6, 1962) [27 FR 11316].

(b) *Information requirements—(1) When information must be furnished.*

(i) If the issuer sells securities either under § 230.504 or only to accredited investors, paragraph (b) of this § 230.502 does not require that specific information be furnished to purchasers.

(ii) If the issuer sells securities under § 230.505 or 230.506 to any purchaser that is not an accredited investor, the issuer shall furnish the information specified in paragraph (b)(2) of this section to all purchasers during the course of the offering and prior to sale.

(2) *Type of information to be furnished.* (i) If the issuer is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, the issuer shall furnish the following information, to the extent material to an understanding of the issuer, its business, and the securities being offered:

(A) *Offerings up to \$5,000,000.* The same kind of information as would be required in Part I of Form S-18 (17 CFR 239.28), except that only the financial statements for the issuer's most recent fiscal year must be certi-

fied by an independent public or certified accountant. If Form S-18 is not available to an issuer, then the issuer shall furnish the same kind of information as would be required in Part I of a registration statement filed under the Act on the form that the issuer would be entitled to use, except that only the financial statements for the most recent two fiscal years prepared in accordance with generally accepted accounting principles shall be furnished and only the financial statements for the issuer's most recent fiscal year shall be certified by an independent public or certified accountant. If an issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

(B) *Offerings over \$5,000,000.* The same kind of information as would be required in Part I of a registration statement filed under the Act on the form that the issuer would be entitled to use. If an issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

(C) If the issuer is a foreign private issuer eligible to use Form 20-F

(§ 249.220f of this chapter) the issuer shall disclose the same kind of information required to be included in a registration statement filed under the Act on the form that the issuer would be entitled to use. The financial statements need be certified only to the extent required by paragraphs (b)(2)(i)(A) or (B) as appropriate.

(ii) If the issuer is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, the issuer shall furnish the information specified in paragraph (b)(2)(ii) (A) or (B) of this section, and in either event the information specified in paragraph (b)(2)(ii)(C) of this section:

(A) The issuer's annual report to shareholders for the most recent fiscal year, if such annual report meets the requirements of § 240.14a-3 or 240.14c-3 under the Exchange Act, the definitive proxy statement filed in connection with that annual report, and, if requested by the purchaser in writing, a copy of the issuer's most recent Form 10-K (17 CFR 249.310) under the Exchange Act.

(B) The information contained in an annual report on Form 10-K under the Exchange Act or in a registration statement on Form S-1 (17 CFR 239.11) under the Act or on Form 10 (17 CFR 249.210) under the Exchange Act, whichever filing is the most recent required to be filed.

(C) The information contained in any reports or documents required to be filed by the issuer under sections 13(a), 14(a), 14(c), and 15(d) of the Exchange Act since the distribution or filing of the report or registration statement specified in paragraphs (b)(2)(ii) (A) or (B), and a brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs that are not disclosed in the documents furnished.

(D) If the issuer is foreign private issuer eligible to use Form 20-F, the issuer may provide in lieu of the information specified in paragraphs (b)(2)(ii) (A) or (B) of this section, the information contained in its most recent filing on Form 20-F or Form F-1 (§ 239.31 of the chapter).

(iii) Exhibits required to be filed with the Commission as part of a reg-

istration statement or report, other than an annual report to shareholders or parts of that report incorporated by reference in a Form 10-K report, need not be furnished to each purchaser if the contents of the exhibits are identified and the exhibits are made available to the purchaser, upon his written request, prior to his purchase.

(iv) At a reasonable time prior to the purchase of securities by any purchaser that is not an accredited investor in a transaction under § 230.505 or § 230.506, the issuer shall furnish the purchaser a brief description in writing of any written information concerning the offering that has been provided by the issuer to any accredited investor. The issuer shall furnish any portion or all of this information to the purchaser, upon his written request, prior to his purchase.

(v) The issuer shall also make available to each purchaser at a reasonable time prior to his purchase of securities in a transaction under § 230.505 or § 230.506 the opportunity to ask questions and receive answers concerning the terms and conditions of the offering and to obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense that is necessary to verify the accuracy of information furnished under paragraph (b)(2) (i) or (ii) of this section.

(vi) For business combinations, in addition to information required by paragraph (b)(2) of this section, the issuer shall provide to each purchaser at the time the plan is submitted to security holders, or, with an exchange, during the course of the transaction and prior to sale, written information about any terms or arrangements of the proposed transaction that are materially different from those for all other security holders.

(c) *Limitation on manner of offering.* Except as provided in § 230.504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar

media or broadcast over television or radio; and

(2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

(d) *Limitations on resale.* Except as provided in § 230.504(b)(1), securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under section 4(2) of the Act and cannot be resold without registration under the Act or an exemption therefrom. The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(11) of the Act, which reasonable care shall include, but not be limited to, the following:

(1) Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons;

(2) Written disclosure to each purchaser prior to sale that the securities have not been registered under the Act and, therefore, cannot be resold unless they are registered under the Act or unless an exemption from registration is available; and

(3) Placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities.

(Secs. 6, 7, 8, 10, 19(a), 48 Stat. 78, 79, 81, 85; secs. 205, 209, 48 Stat. 906, 908; sec. 301, 54 Stat. 857; sec. 8, 68 Stat. 685; sec. 1, 79 Stat. 1051; sec. 308(a)(2), 90 Stat. 57; secs. 12, 13, 15(d), 23(a), 48 Stat. 892, 894, 895, 901; secs. 1, 3, 8, 49 Stat. 1375, 1377, 1379; sec. 203(a), 49 Stat. 704; sec. 202, 68 Stat. 686; secs. 3, 4, 6, 78 Stat. 565-568, 569, 570-574; secs. 1, 2, 82 Stat. 454; sec. 28(c), 84 Stat. 1435; secs. 1, 2, 84 Stat. 1497; sec. 105(b), 88 Stat. 1503; secs. 8, 9, 10, 18, 89 Stat. 117, 118, 119, 155; sec. 308(b), 90 Stat. 57; secs. 202, 203, 204, 91 Stat. 1494, 1498, 1499, 1500; secs. 8 30, 31(c), 38(a), 54 Stat. 803, 836, 838, 841; 74 Stat. 201; 84 Stat. 1415; 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 78f, 78m, 78o(d), 78w(a), 80a-8, 80a-29, 80a-30(c), 80a-37(a))

[47 FR 11262, Mar. 16, 1982, as amended at 47 FR 54771, Dec. 6, 1982]

§ 230.503 Filing of notice of sales.

(a) The issuer shall file with the Commission five copies of a notice on

Form D (17 CFR 239.500) no later than 15 days after the first sale of securities in an offering under Regulation D.

(b) One copy of every notice on Form D shall be manually signed by a person duly authorized by the issuer.

(c) If sales are made under § 230.505, the notice shall contain an undertaking by the issuer to furnish to the Commission, upon the written request of its staff, the information furnished by the issuer under § 230.502(b)(2) to any purchaser that is not an accredited investor.

(d) Amendments to notices filed under paragraph (a) of this section need only report the issuer's name and the information required by Part C and any material change in the facts from those set forth in Parts A and B.

(e) A notice on Form D shall be considered filed with the Commission under paragraph (a) of this section.

(1) As of the date on which it is received at the Commission's principal office in Washington, DC; or

(2) As of the date on which the notice is mailed by means of United States registered or certified mail to the Commission's principal office in Washington, DC, if the notice is delivered to such office after the date on which it is required to be filed.

[51 FR 36386, Oct. 10, 1986]

§ 230.504 Exemption for limited offers and sales of securities not exceeding \$500,000.

(a) *Exemption.* Offers and sales of securities that satisfy the conditions in paragraph (b) of this section by an issuer that is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act and that is not an investment company shall be exempt from the provisions of section 5 of the Act under section 3(b) of the Act.

(b) *Conditions to be met—(1) General conditions.* To qualify for exemption under this section offers and sales must satisfy the terms and conditions of §§ 230.501 through 230.503, except that the provisions of §§ 230.502 (c) and (d) shall not apply to offers and sales of securities under this section that are made exclusively in one or more states each of which provides for

the registration of the securities and requires the delivery of a disclosure document before sale and that are made in accordance with those state provisions.

(2) *Specific condition—(i) Limitation on aggregate offering price.* The aggregate offering price for an offering of securities under this § 230.504, as defined in § 230.501(c), shall not exceed \$500,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this section in reliance on any exemption under section 3(b) of the Act or in violation of section 5(a) of the Act.

NOTE 1: The calculation of the aggregate offering price is illustrated as follows:

EXAMPLE 1. If an issuer sold \$200,000 of its securities on June 1, 1982 under this § 230.504 and an additional \$100,000 on September 1, 1982, the issuer would be permitted to sell only \$200,000 more under this § 230.504 until June 1, 1983. Until that date the issuer must count both prior sales toward the \$500,000 limit. However, if the issuer made its third sale on June 1, 1983, the issuer could then sell \$400,000 of its securities because the June 1, 1982 sale would not be within the preceding twelve months.

EXAMPLE 2. If an issuer sold \$100,000 of its securities on June 1, 1982 under this § 230.504 and an additional \$4,500,000 on December 1, 1982 under § 230.505, the issuer could not sell any of its securities under this § 230.504 until December 1, 1983. Until then the issuer must count the December 1, 1982 sale towards the limit of \$500,000 within the preceding twelve months.

NOTE 2: If a transaction under this section fails to meet the limitation on the aggregate offering price, it does not affect the availability of this Section for the other transactions considered in applying such limitation. For example, if the issuer in Example 1 made its third sale on May 31, 1983, in the amount of \$250,000, this § 230.504 would not be available for that sale, but the exemption for the prior two sales would be unaffected.

§ 230.505 Exemption for limited offers and sales of securities not exceeding \$5,000,000.

(a) *Exemption.* Offers and sales of securities that satisfy the conditions in paragraph (b) of this section by an issuer that is not an investment company shall be exempt from the provisions of section 5 of the Act under section 3(b) of the Act.

(b) *Conditions to be met*—(1) *General conditions.* To qualify for exemption under this section, offers and sales must satisfy the terms and conditions of §§ 230.501 through 230.503.

(2) *Specific conditions*—(i) *Limitation on aggregate offering price.* The aggregate offering price for an offering of securities under this § 230.505, as defined in § 203.501(c), shall not exceed \$5,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this section in reliance on any exemption under section 3(b) of the Act or in violation of section 5(a) of the Act.

NOTE: The calculation of the aggregate offering price is illustrated as follows:

EXAMPLE 1. If an issuer sold \$2,000,000 of its securities on June 1, 1982 under this § 230.505 and an additional \$1,000,000 on September 1, 1982, the issuer would be permitted to sell only \$2,000,000 more under this § 230.505 until June 1, 1983. Until that date the issuer must count both prior sales towards the \$5,000,000 limit. However, if the issuer made its third sale on June 1, 1983, the issuer could then sell \$4,000,000 of its securities because the June 1, 1982 sale would not be within the preceding twelve months.

EXAMPLE 2. If an issuer sold \$500,000 of its securities on June 1, 1982 under § 230.504 and an additional \$4,500,000 on December 1, 1982 under this section, then the issuer could not sell any of its securities under this section until June 1, 1983. At that time it could sell an additional \$500,000 of its securities.

(ii) *Limitation on number of purchasers.* The issuer shall reasonably believe that there are no more than 35 purchasers of securities from the issuer in any offering under this section.

NOTE: See § 230.501(e) for the calculation of the number of purchasers and § 230.502(a) for what may or may not constitute an offering under this section.

(iii) *Disqualifications.* No exemption under this section shall be available for the securities of any issuer described in § 230.252(c), (d), (e), or (f) of regulation A, except that for purposes of this section only:

(A) The term "filing of the notification required by § 230.255" as used in § 230.252(c), (d), (e) and (f) shall mean

the first sale of securities under this section;

(B) The term "underwriter" as used in § 230.252(d) and (e) shall mean a person that has been or will be paid directly or indirectly remuneration for solicitation of purchasers in connection with sales of securities under this section; and

(C) Paragraph (b)(2)(iii) of this section shall not apply to any issuer if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied. Any such determination shall be without prejudice to any other action by the Commission in any other proceeding or matter with respect to the issuer or any other person.

§ 230.506 Exemption for limited offers and sales without regard to dollar amount of offering.

(a) *Exemption.* Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act.

(b) *Conditions to be met*—(1) *General conditions.* To qualify for exemption under this section, offers and sales must satisfy all the terms and conditions of §§ 230.501 through 230.503.

(2) *Specific conditions*—(i) *Limitation on number of purchasers.* The issuer shall reasonably believe that there are no more than 35 purchasers of securities from the issuer in any offering under this section.

NOTE: See § 230.501(e) for the calculation of the number of purchasers and § 230.502(a) for what may or may not constitute an offering under this section.

(ii) *Nature of purchasers.* The issuer shall reasonably believe immediately prior to making any sale that each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.

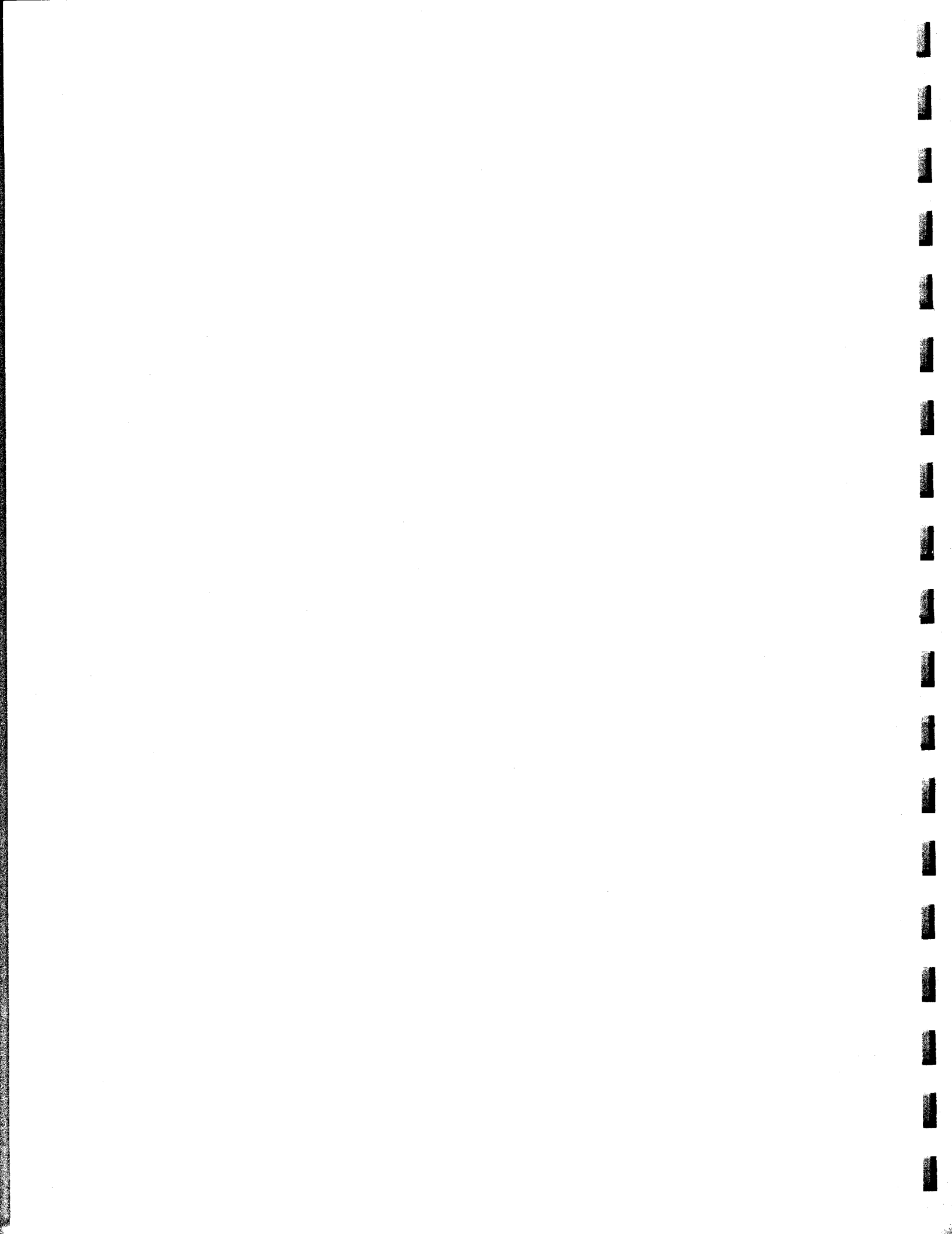
INTRASTATE OFFERINGS FINANCING OPPORTUNITIES FOR LOCAL BUSINESSES

WITH LOCAL INVESTORS

Gary L. Stage
Stoll, Keenon and Parks
Lexington, Kentucky

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SECTION I



INTRASTATE OFFERINGS
FINANCING OPPORTUNITIES FOR LOCAL BUSINESSES
WITH LOCAL INVESTORS

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1. The first part of the document discusses the importance of maintaining accurate records of all transactions. This is essential for ensuring the integrity of the financial statements and for providing a clear audit trail.

2. The second part of the document outlines the various methods used to collect and analyze data. These methods include direct observation, interviews, and the use of specialized software tools.

3. The third part of the document describes the process of identifying and classifying data. This involves determining the source of the data and the context in which it was collected.

4. The fourth part of the document discusses the importance of data security and privacy. It emphasizes the need to protect sensitive information from unauthorized access and disclosure.

5. The fifth part of the document outlines the various methods used to analyze and interpret data. This includes statistical analysis, trend analysis, and the use of decision support systems.

6. The sixth part of the document describes the process of reporting and communicating the results of the analysis. This involves preparing clear and concise reports that provide actionable insights.

7. The seventh part of the document discusses the importance of ongoing monitoring and evaluation. This ensures that the data remains current and that the analysis continues to provide relevant information.

8. The eighth part of the document outlines the various methods used to ensure the quality and reliability of the data. This includes implementing rigorous data collection procedures and using validated measurement tools.

9. The ninth part of the document describes the process of identifying and addressing potential biases in the data. This is crucial for ensuring that the analysis is objective and unbiased.

10. The tenth part of the document discusses the importance of data governance and compliance. This involves establishing clear policies and procedures for the management and use of data.

11. The eleventh part of the document outlines the various methods used to ensure the transparency and accountability of the data analysis process. This includes documenting all steps and decisions made during the analysis.

12. The twelfth part of the document describes the process of sharing and disseminating the results of the analysis. This involves using appropriate channels and formats to reach the intended audience.

13. The thirteenth part of the document discusses the importance of data literacy and skills. This involves providing training and education to ensure that all stakeholders are able to effectively use and interpret data.

14. The fourteenth part of the document outlines the various methods used to ensure the sustainability of the data analysis process. This includes developing long-term plans and strategies for data management and analysis.

15. The fifteenth part of the document describes the process of evaluating the effectiveness of the data analysis process. This involves using a variety of metrics and indicators to assess performance and identify areas for improvement.

16. The sixteenth part of the document discusses the importance of data ethics and responsible data use. This involves ensuring that data is collected and used in a way that respects individual privacy and rights.

17. The seventeenth part of the document outlines the various methods used to ensure the accuracy and reliability of the data. This includes implementing rigorous data collection procedures and using validated measurement tools.

18. The eighteenth part of the document describes the process of identifying and addressing potential biases in the data. This is crucial for ensuring that the analysis is objective and unbiased.

19. The nineteenth part of the document discusses the importance of data governance and compliance. This involves establishing clear policies and procedures for the management and use of data.

INTRASTATE OFFERINGS
FINANCING OPPORTUNITIES FOR LOCAL BUSINESSES
WITH LOCAL INVESTORS

Seminar on Securities Law
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University of Kentucky College of Law
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Gary L. Stage
Stoll, Keenon & Park
Lexington, Kentucky

I. The Intrastate Offering Exemption

A. Section 3(a)(11) of the Securities Act of 1933

1. Section 3(a)(11) of the Securities Act of 1933 (the "Act") exempts from the registration and prospectus delivery requirements of Section 5 of the Act "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within such State or Territory."
2. "The legislative history of . . . Section [3(a)(11)] suggests that the exemption was intended to apply only to issues genuinely local in character, which in reality represent local financing by the local industries, carried out through local investment." Preliminary Note 3 to SEC Rule 147, SEC Securities Act Release No. 33-5450 (Jan. 7, 1974.)
3. The imprecise language of the statute creates various problems and issues as to the availability of the statutory exemption. Reliance solely on the statutory exemption is risky because of the narrow construction given the exemption by the courts and the Securities and Exchange Commission (the "SEC"). See, e.g., SEC Securities Act Release No. 33-4434 (Dec. 6, 1961); Busch v. Carpenter, 827 F.2d 653 (10th Cir. 1987); and SEC v. Truckee Showboat, Inc., 175 F. Supp. 824 (S.D. Cal. 1957).

B. SEC Rule 147

1. In 1974, the SEC adopted Rule 147 in order "to provide more objective standards upon which responsible local businessmen intending to raise capital from local sources may rely in claiming the Section 3(a)(11) exemption." Preliminary Note 3 to Rule 147. Thus, Rule 147 provides a "safe harbor" concerning the use of the Section 3(a)(11) intrastate exemption.
2. The Rule is not exclusive, however, and an issuer can still, by relying on existing administrative and judicial interpretations relating to Section 3(a)(11), attempt to make an offering pursuant to the statutory exemption.
3. Rule 147 has five basic requirements:
 - (a) The issuer must be a "resident" of, or if a corporation, incorporated in, the state in which all of the securities are offered and sold;
 - (b) The issuer must be "doing business" within the state in which all of the securities are offered and sold;
 - (c) All offerees and purchasers of the securities must be "residents" of the state in which all of the securities are offered and sold;
 - (d) The securities must "come to rest" in the state in which offered and sold (i.e., the securities must remain in the hands of state residents for a certain period of time); and
 - (e) The securities must not be part of (i.e., "integrated" with) a larger financing plan for which the exemption would be unavailable.
4. The SEC has taken the position that because of the adoption of the Rule 147 safe harbor provisions, no-action letters on the availability of Section 3(a)(11) will be issued "only in the most compelling circumstances." SEC Securities Act Release No. 33-6253 (Oct. 28, 1980). SEC no-action letters are referenced in this outline by title and date available.
5. The full text of Rule 147 is set forth as an Appendix to this outline.

C. Transactions Covered: Rule 147(a)

1. Rule 147 exempts only specific transactions, and not the securities themselves, from registration.
2. Rule 147 "provides an exemption for offers and sales by the issuer only. It is not available for offers or sales of securities by other persons." Preliminary Note 4 to Rule 147. It should be noted, however, that:

(a) Broker-dealers, underwriters and selling agents can be used in effecting a Rule 147 offering. See Wortman and Mann, Inc. (Dec. 16, 1974); and Eastern Ill. Tel. Corp. (April 14, 1975).

(b) "Section 3(a)(11) of the Act has been interpreted to permit offers and sales by persons controlling the issuer, if the exemption provided by that Section would have been available to the issuer at the time of the offering." Preliminary Note 4 to Rule 147. See SEC Securities Act Release No. 33-4434 (Dec. 6, 1961). Thus, certain secondary distributions may be made in reliance on the Section 3(a)(11) statutory exemption, but not SEC Rule 147. Also note, however, that:

(i) Reliance solely on the statutory exemption presents a greater degree of risk, including the risk of tainting the entire transaction (i.e., both the primary offering by the issuer and the secondary distribution).

(ii) Certain practical problems are likely to be encountered in using the statutory intrastate offering to effect such a secondary distribution. See Hicks, Intrastate Offerings Under Rule 147, 72 Mich. L. Rev. 463, 467 (1974).

II. Requirements of Rule 147

A. Residency of Issuer. Rule 147 requires that the issuer be a "resident" of the state in which all offers and sales of the securities are made.

1. Prior to determining whether the issuer is a resident of a particular state, the issuer must be properly identified.

(a) An existing corporation or partnership is the issuer of the securities of the entity.

(b) The entity or individual offering subscriptions to securities of a yet-to-be-formed corporation or partnership will be considered the issuer. See Bernard E. Schneider, Esq., Virtue & Scheck (Oct. 15, 1986); and SEC Securities Act Release No. 33-5450 (Jan. 7, 1974), Paragraph 4 of "Synopsis of Rule 147."

(c) When the issuer's activities are closely related to and dependent upon another entity or individual, such other entity or individual may be treated as a co-issuer for purposes of Rule 147. In Film Festival 82 (June 25, 1982), Film Festival 82, a California limited partnership, entered into a joint venture with ComWorld Group. The SEC combined the two entities for purposes of the availability of the Rule 147 exemption because Film Festival 82's only purpose was to finance the business activities of ComWorld Group and would perform few, if any, activities independent of ComWorld Group.

(d) If a parent corporation and its subsidiaries are incorporated in different states, the corporate group is considered a single entity and the intrastate exemption is unavailable. See Liberty Loan Corp. (Dec. 26, 1974); and Citicorp (May 24, 1974).

2. Rule 147(c)(1) provides three rules for determining the residency of the issuer.

(a) Business entities organized or incorporated under state law are considered residents of the state of organization or incorporation. Rule 147(c)(1)(i). This provision would apply to corporations (Paul Pasquariello (Aug. 27, 1976)), limited partnerships (Landura Corp. of North Carolina (Feb. 6, 1975)) and trusts (see, e.g., Genesee Merchants Bank & Trust Co. (Feb. 1, 1982)). This section does not apply to entities organized under Federal law (e.g., national banks) which must use the principal office test described below. See Owensboro Nat'l Bank (July 29, 1981).

(b) If the issuer is a general partnership or other business organization not organized under state law, the location of the issuer's principal office will determine residency. Rule 147(c)(1)(ii). The issuer's principal office is located where the issuer's principal banking, purchasing, legal, accounting and logistical functions are performed, which may be different than the place where the business activity of the

organization is focused. CEDC Sales, Inc. (Alaska Commercial Co.) (Feb. 10, 1981).

(c) If an individual is the issuer, then the location of his principal residence is determinative. Rule 147(c)(1)(iii).

(i) This provision would apply, for example, to pre-incorporation offers of stock subscriptions by a promoter or to pre-formation offers of subscriptions for partnership interests by the general partner of a limited partnership. See Schneider, supra.

(ii) Determining the principal residence of an individual is not always easy. If, for example, the individual maintains more than one place of residence, traditional principles to determine legal domicile must be applied. See the discussion below concerning identifying the location of the principal residence of individual offerees/purchasers.

B. "Doing Business" in the State. Under Rule 147, the issuer must also be "doing business" within the state in which all offers and sales of the securities are made. The issuer will be considered "doing business" within the state only if it meets all four of the following tests, as set forth in Rule 147(c)(2).

1. The Gross Revenues Test. This test requires that the issuer, and all of its subsidiaries on a consolidated basis, derive at least 80% of its gross revenues from the operation of a business or of real estate or from the rendering of services within the state. Rule 147(c)(2)(i).

(a) The time period to be used in applying this test depends upon the date the securities are first offered.

(i) If the offering is made during the first six months of the issuer's fiscal year, the gross revenues test is based on the issuer's last completed fiscal year revenues. Rule 147(c)(2)(i)(A).

(ii) If the offering is made during the last six months of the issuer's fiscal year, the issuer can elect to base the gross revenues test on the issuer's gross revenues for either the first six months of the current fiscal year or the prior 12-month period. Rule 147(c)(2)(i)(B).

(iii) The gross revenues test does not apply to issuers with less than \$5,000 of gross revenue during the past 12 months. Id.

(b) No-Action Letters

(i) Issuers attempting to develop and distribute movies or television programs cannot utilize Rule 147 unless at least 80% of the revenue is derived from the distribution and exhibition of the film within the state. See, e.g., David S. Cook (Sept. 7, 1986); Film Festival '82 (June 25, 1982); and Coweta Movie Assoc. (Nov. 11, 1977).

(ii) Issuers which invest money on out-of-state exchanges can qualify for the 80% test if a substantial part of the advisor's and broker's activities were conducted in the state. See Eugene T. Ichinose, Jr. (Feb. 15, 1979); and Thomas Beard (Dec. 30, 1976).

(iii) Issuers with out-of-state offices can look to the location of the office, rather than the location of the customer, to determine if the 80% test is satisfied. For example, if the issuer had total out-of-state sales of 23%, but an out-of-state branch generated only 14% of the out-of-state sales, the test is satisfied. Medix of Wisconsin, Inc. (June 17, 1976). The SEC has stated that revenues will be attributed to an out-of-state office when "activities are conducted by out-of-state employees and the revenues derived from those activities are the result of decision making authority that is exercised out of state." Interstate Sec. Corp. (Nov. 15, 1982).

2. The Location of Assets Test. This test requires that, at the end of the issuer's most recent semi-annual fiscal period prior to the first offer of any part of the issue, at least 80% of the issuer's assets (and those of its subsidiaries on a consolidated basis) must be located in the state in which all offers and sales of the securities are made. Rule 147(c) (2) (i).

(a) The SEC has stated that the book value (based on Generally Accepting Accounting Principles), not the fair market value, of assets is to be used in applying the location of assets test. See Berkley & Co., Inc. (December 11, 1975).

(b) Leased equipment has been involved in several of the questions presented in no-action letters.

(i) Financial Accounting Standards Board Statement No. 13 ("FASB 13") is controlling in determining the location of leased assets. Leastec Corp. (June 9, 1984).

(ii) "Operating leases" are reported under FASB 13 as if the lessor is the owner of the asset. A leasing venture's assets would therefore be the equipment itself and the location of the equipment would be determinative. Id.

(iii) "Sales type" leases or "direct financing" leases are reported as accounts receivable under FASB 13. Therefore, the location of the principal office of the leasing venture, rather than the location of the leased assets, is determinative. Id.

3. Use of Net Proceeds Test. This test requires that the issuer intend to use and actually use at least 80% of the net proceeds from sales made under Rule 147 "in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state" Rule 147(c)(2)(iii).

(a) The test does not require the purchase of goods or materials in-state, but rather that such items purchased will be used in the state. H-R 10 Master Plan & Group Trust of Maryland (Jan. 5, 1975).

(b) The SEC has allowed a majority of the proceeds to be used to retire an out-of-state debt resulting from the acquisition of stock in a bank with greater than 80% of its business in-state, Fina Bancorp, Inc., (June 15, 1987). It has also allowed 20% of the proceeds to be used to satisfy an out-of-state debt originally incurred to acquire property and equipment brought into the state. Pilgrims Inns, Inc. (Mar. 21, 1975).

(c) The use of offering proceeds to purchase assets on a regulated exchange will not preclude the use of Rule 147. Genesee Merchants Bank & Trust Co. (Dec. 30, 1981).

(d) Investment in art purchased out-of-state for resale to non-resident buyers does not meet the

test, however. Consortium Fund No. 1 (Sept. 5, 1975).

4. The Principal Office Location Test. This test requires that the issuer's principal office be located in the state in which all offers and sales of the securities are made. Rule 147(c)(2)(iv). The issuer's principal office is located where the issuer's principal banking, accounting and legal requirements are met and the issuer's buyers and officers are located. CEDC Sales, Inc. (Alaska Commercial Co.) (Feb. 10, 1981).

5. Rule 147 Hypotheticals. In SEC Securities Act Release No. 33-5450 (Jan. 7, 1974), the SEC posed five hypothetical situations concerning the application of the four "doing business" tests and provided comments as to the application of these tests to these situations.

(a) The first hypothetical presents a corporation which is incorporated and has its administrative headquarters and manufacturing and storage facilities within the state. The corporation manufactures all of the products in the state and sells its products by mail order throughout the United States. This operation, according to the Release, would meet all four "doing business" tests. Additionally, based on the second hypothetical, the corporation would satisfy all four "doing business" tests if it did not manufacture its products in-state, but rather purchased inventory from out-of-state to be shipped to its in-state warehouse for distribution.

(b) The third hypothetical involves a land development corporation in the business of selling property located in several states, but with its principal office located in the state in which all offers and sales of the securities are made. The SEC took no position on these facts, but indicated that the asset and gross revenues tests may not be met if the developer owned the out-of-state property, as opposed to acting as agent for the owner. In addition, the SEC indicated that 80% of the net proceeds of the Rule 147 offering must be used to buy property located in the state to qualify under Rule 147.

(c) The fourth and fifth hypotheticals involve an engineering consulting firm organized under the law of, and with its only office in, the state in which all offers and sales of the securities are made. However, the firm is involved in projects

outside of the state. 75% of the work on the out-of-state projects is done in the home office and 50% of the firm's revenues is from these projects. The SEC took the position that all four "doing business" tests were satisfied. The only real question involved the gross revenues test, which the SEC apparently decided was satisfied because a majority of the work on these projects was performed in the state. The fifth hypothetical added additional assets of the firm in the form of accounts receivable, 25% of which are from out-of-state clients. Again, the SEC concluded that all four "doing business" tests would be met.

C. Residence of Offerees and Purchasers. Rule 147(d) requires that all offerees and purchasers be "residents" of the same state as the issuer.

1. The Rule identifies three separate types of possible offerees and purchasers: (a) corporations, partnerships, trusts and other business organizations, (b) individuals and (c) entities organized for the specific purpose of acquiring securities offered under Rule 147. Note that:

(a) The rules for determining the "residence" of offerees and purchasers are similar but not identical to the rules described above for determining the "residence" of the issuer.

(b) The residency test for all offerees and purchasers must be met both at the time of all offers and at the time of all sales of the securities.

2. Rules for determining residency of offerees and purchasers:

(a) Corporations, Partnerships, Trusts and Other Business Organizations. Rule 147(d)(1) provides that, for this purpose, residence of an offeree/purchaser is determined by the state in which a corporation, partnership, trust or other business organization has its principal office, rather than by its state of organization.

(i) Normally there need be no inquiry into the residence of the underlying owners of such business entities, provided that the entity is not organized for the specific purpose of investing in the securities offered in the Rule 147 offering and that it actually conducts business in the state.

See, e.g., North American Investments (March 17, 1980).

(ii) Rule 147(d), unlike Rule 147(c) dealing with the issuer's residence, makes no distinction between general and limited partnerships. The location of a general partnership's principal office therefore determines its residence for purposes of its status as both an issuer and an offeree/purchaser. See FNB Products, Inc. (Dec. 4, 1975).

(b) Individuals. An individual offeree/purchaser is deemed to be resident of the state in which his principal residence is located. Rule 147(d)(2). When an individual maintains residences in more than one state, principal residence will be determined by the traditional incidents of legal domicile, such as where the person is registered to vote, has obtained a driver's license, files income tax returns and works. Additional considerations would be the place in which the person spends the majority of time and the person's family is located. See Palm Resaca Corp. (Sept. 24, 1979); and United Educators, Inc. (Nov. 19, 1976).

(c) Entities Formed to Invest in a Rule 147 Offering. If an entity is organized for the specific purpose of acquiring securities offered in a Rule 147 offering, all beneficial owners of the entity must be residents of the same state as the issuer in order to qualify under Rule 147(d)(3).

(i) Entities previously organized and conducting prior activities will not be treated as organized for the specific purpose of investing in the Rule 147 offering. See FNB Products, Inc. (Dec. 4, 1975).

(ii) It is necessary to "look through" an existing business organization to the residence of its owners when the entity has only a custodial role in holding shares obtained in a Rule 147 offering. See Fair Valley Properties No. 2 (April 2, 1981); and ABT Bancshares Corp. (June 24, 1981).

(d) No-Action Letters.

(i) The requirement that the residency test for offerees/purchasers be met at the time of both the offer and the purchase of the

securities creates difficulty with regard to securities sold and purchased on an installment basis. In one situation the SEC took the position that where the purchase price for the securities was payable over a 36-month period, Rule 147 was unavailable because the residence of the offerees/purchasers could change before the sale was consummated. Opportunities Inv. Assoc. of New London, Conn. (July 14, 1978). However, the SEC has also taken the position, which appears to represent the SEC's current view, that installment sales of limited partnership interests will qualify for Rule 147 when substantial penalties exist for non-payment of an installment. The Diplomat Ltd. (Feb. 13, 1984).

(ii) The cash-out of two non-resident shareholders in a merger/reorganization transaction in which resident shareholders received stock of the acquiring company did not preclude use of Rule 147. However, the issuance of preferred stock and cash to a trustee for non-resident shareholders to be held until the residents became state residents could destroy the availability of the Rule 147 exemption. Great Southwestern Financial Corporation (Dec. 30, 1982); and First National Bank & Trust Co. of Perry, Okla. (Dec. 19, 1985).

(iii) The offer and sale of securities to non-U.S. citizens would not preclude the use of Rule 147. First National Bank & Trust Co. of Perry, Okla., supra. The SEC has reaffirmed this position in two recent no-action letters. Wagner, Rummonds, Murphy & Vaughn, (Mar. 12, 1987); and Commonwealth Equity Trust (Feb. 20, 1987). In each instance, however, the SEC emphasized that it expressed no opinion as to whether and under what circumstances the securities sold to non-U.S. citizens could be reoffered and resold in the United States or to citizens or residents of the United States. In issuing these no-action letters, the SEC also noted that it was relying on representations that there would be full compliance with the requirements of Rule 147(e), which imposes limitations on resale of the securities, and of Rule 147(f), which requires the issuer to take certain precautions to prevent interstate offers and sales of the securities, all

of which requirements are discussed more fully below.

(iv) A trustee will not be considered an offeree/purchaser under Rule 147(d) if the trustee performs only custodian or ministerial functions and all investment decisions are made by investors in the trust fund. Edmunds & Assoc. Inc. Realtors (Nov. 20, 1975); and University Real Estate Partnership V (Mar. 7, 1978).

(v) If the trustee (rather than the beneficiaries) is deemed to be the offeree/purchaser, continuation of the trust "until the offering comes to rest" is critical. Mid-Continental Bancorporation, Inc. (May 23, 1979).

D. Resale Restrictions and Precautions Against Interstate Offers and Sales. An additional requirement for the availability of Rule 147 is that the securities "come to rest" in the state in which the securities are offered and sold. This requirement is imposed by means of a restriction on the resale of the securities. In addition, the issuer is required to take certain precautions against interstate offers and sales.

1. Limitations on Resale. Rule 147(e) provides that during the period the securities are being offered and sold and for a period of nine months from the date of the last sale by the issuer of such securities, all resales of such securities by any person shall be made only to persons resident within the same state.

(a) With regard to convertible securities, a sale or resale of either the convertible security or the underlying security to a non-resident within the nine-month period would destroy the exemption. For purposes of the Rule, a conversion will not start a new nine-month period. See Rule 147(e), Note 1.

(b) The nine-month resale restriction period on securities purchased and sold on an installment basis under Rule 147 does not start until the final installment is paid. See Opportunities Inv. Assoc. of New London, Conn. (July 14, 1978).

(c) The SEC has allowed Rule 147 to be used in a merger where securities were to be issued to a resident corporation with pre-existing plans to liquidate and distribute the securities to

non-residents. The SEC required representations that the liquidation and distribution would occur no earlier than nine months after completion of the Rule 147 offering. BSD Bancorp, Inc. (May 10, 1982).

(d) In a no-action letter involving use of Rule 147 in connection with an employee stock option plan, the SEC noted: "[T]he determination as to whether the . . . exemption is available should be made with respect to the entire issue of securities, not merely with respect to each individual exercise of an option. In general, the exercise of options by employees pursuant to the same plan would appear to constitute part of the same issue of securities. Accordingly, the requirements of the exemption would have to be met with respect to the exercise of all of the options. In this regard, the nine month period, specified in Rule 147, during which the shares must come to rest within the state would not commence until the entire offering of the shares had been completed as a result of the exercise of all of the outstanding options, rather than commencing with respect to an individual nine months after he exercises an option." Synbiotics Corp. (Aug. 22, 1985).

2. Precautions Against Interstate Offers and Sales. Rule 147(f) requires the issuer to take certain precautions to prevent interstate offers and sales of securities in violation of the Rule.

(a) In connection with all securities sold under Rule 147 the issuer must:

(i) Place a legend on each certificate stating that the securities have not been registered under the Act and setting forth the resale restrictions described above;

(ii) Issue stop transfer instructions to its transfer agent, or enter an appropriate notation in its own books and records if it is acting as its own transfer agent; and

(iii) Obtain a written representation from each purchaser as to his residence.

(b) If any of the securities are transferred during the nine-month period, the issuer must place the same restrictive legend on the certificate and take the same stop transfer measures, both as described above.

(c) The issuer must also disclose in writing to all offerees and purchasers the restrictions on resale of the securities and the precautions against interstate offers and sales of the securities that will be imposed, as described above.

E. Integration. Rule 147(b) deals with the concept of "integration", that is, what securities of the issuer constitute part of an "issue".

1. In order for the Rule 147 exemption to be available, "all securities of the issuer which are part of an issue" must be offered and sold in compliance with all of the requirements of the Rule. Rule 147(b)(1). Therefore, Rule 147 cannot be used to offer and sell part of an issue, if another part of the same issue is being offered and sold to non-residents in reliance on a different exemption. The problem is determining what offerings will be considered part of the same issue.
2. Rule 142(b)(2) sets forth a "safe harbor" provision concerning integration, stating that an issue shall not include offers and sales which take place prior to the six-month period immediately preceding or after the six-month period immediately following any offers or sales made pursuant to Rule 147, provided that during either of the two six-month periods there are no offers or sales by or for the issuer of the same or a similar class of securities as those offered or sold under the Rule.
3. If this integration safe harbor rule cannot be used, the determination of whether offers and/or sales of other securities must be integrated with the Rule 147 offering will depend upon the application of traditional integration concepts. As set forth in Preliminary Note 3 to Rule 147, the factors to be considered in determining whether offerings must be integrated include whether:
 - (a) The offerings are part of a single plan of financing.
 - (b) The offerings involve issuance of the same class of securities.
 - (c) The offerings are made at or about the same time.
 - (d) The same type of consideration is to be received.

(e) The offerings are made for the same general purpose.

4. Applying these factors to determine whether multiple offerings should be integrated depends upon analysis of all relevant facts and circumstances and can often present a very difficult problem. This difficulty is exemplified by the fact that for several years the SEC declined to give no-action letters or interpretive advice on integration questions, although the SEC has now resumed responding to such requests. An excellent treatment of the integration doctrine is contained in a Position Paper of the American Bar Association Subcommittee on Partnerships, Trusts and Unincorporated Associations, entitled "Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering," 37 The Business Lawyer 1591 (July 1982).

III. Disclosure Considerations

A. Duty of Full Disclosure of All Material Facts

1. The intrastate exemption afforded by Section 3(a)(11) of the Act and SEC Rule 147 provides an exemption only from the registration and prospectus delivery requirements of Section 5 of the Act. The anti-fraud provisions of the Federal securities laws remain applicable.
2. Pursuant to the anti-fraud provisions of the Federal securities laws it is incumbent upon the issuer to make full and accurate disclosure of all material facts in connection with the offer and sale of the securities. See Sections 12(2) and 17(a)(2) of the Act, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder.

B. Disclosure Documentation

1. Although the intrastate exemption mandates no specific disclosure requirements apart from the general anti-fraud rules described above, it is advisable and extremely important to prepare and to distribute to prospective investors a disclosure document furnishing all material facts about the offering. As a practical matter investors frequently do not read the prospectus, offering circular or private placement memorandum; nevertheless, the disclosure document offers protection against disgruntled investors who subsequently

claim that all material facts were not accurately disclosed.

2. Because there are no specific disclosure requirements, this document need not follow any particular format and it can be relatively short. What this type of disclosure document should do, however, is analyze the offering and the issuer, disclosing all information that a reasonable, prudent investor would deem relevant in making an informed investment decision. At a minimum this should include information concerning:

- (a) The duration and dollar amount of the offering (including minimum and maximum offering amounts, if applicable), and the manner in which the securities are being distributed.

- (b) The anticipated application of the proceeds of the offering, including a description of any property to be acquired.

- (c) The nature of the securities being offered, and all rights and obligations incident to ownership of the securities, including the resale restrictions and precautions against interstate offers and sales described above.

- (d) The identity, history, business and financial condition of the issuer.

- (e) The management of the issuer.

- (f) Compensation and fee arrangements with respect to the offering and the business operations of the issuer.

- (g) All transactions and situations that may result in conflicts of interest in connection with the offering and the contemplated business operations.

- (h) The principal risk factors applicable to the offering and the anticipated business operations, including any significant tax issues.

- (i) The prior performance record of the issuer and its management in other similar offerings or businesses.

- (j) The investment objectives and policies and plan of operation of the issuer.

- (k) Any investor suitability standards.

Rule 147. "Part of an Issue," "Person Resident," and "Doing Business Within" for Purposes of Section 3(a)(11).

Preliminary Notes

1. This rule shall not raise any presumption that the exemption provided by Section 3(a)(11) of the Act is not available for transactions by an issuer which do not satisfy all of the provisions of the rule.

2. Nothing in this rule obviates the need for compliance with any state law relating to the offer and sale of the securities.

3. Section 5 of the Act requires that all securities offered by the use of the mails or by any means or instruments of transportation or communication in interstate commerce be registered with the Commission. Congress, however, provided certain exemptions in the Act from such registration provisions where there was no practical need for registration or where the benefits of registration were too remote. Among those exemptions is that provided by Section 3(a)(11) of the Act for transactions in "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within . . . such State or Territory." The legislative history of that Section suggests that the exemption was intended to apply only to issues genuinely local in character, which in reality represent local financing by the local industries, carried out through local investment. Rule 147 is intended to provide more objective standards upon which responsible local businessmen intending to raise capital from local sources may rely in claiming the Section 3(a)(11) exemption.

All of the terms and conditions of the rule must be satisfied in order for the rule to be available. These are: (i) that the issuer be a resident of and doing business within the state or territory in which all offers and sales are made; and (ii) that no part of the issue to be offered or sold to non-residents within the period of time specified in the rule. For purposes of the rule the definition of "issuer" in Section 2(4) of the Act shall apply.

All offers, offers to sell, offers for sale, and sales which are part of the same issue must meet all of the conditions of Rule 147 for the rule to be available. The determination whether offers, offers to sell, offers for sale and sales of securities are part of the same issue (i.e., are deemed to be "integrated") will continue to be a question of fact and will depend on the particular circumstances. See Securities Act of 1933 Release No. 4434 (December 6, 1961). Release 33-4434 indicates that in determining whether offers and sales should be regarded as part of the same issue and thus should be integrated any one or more of the following factors may be determinative:

- (i) are the offerings part of a single plan of financing;
- (ii) do the offerings involve issuance of the same class of securities;
- (iii) are the offerings made at or about the same time;
- (iv) is the same type of consideration to be received; and
- (v) are the offerings made for the same general purpose.

Subparagraph (b)(2) of the rule, however, is designed to provide certainty to the extent feasible by identifying certain types of offers and sales of securities which will be deemed not part of an issue, for purposes of the rule *only*.

Persons claiming the availability of the rule have the burden of proving that they have satisfied all of its provisions. However, the rule does not establish exclusive standards for complying with the Section 3(a)(11) exemption. The exemption would also be available if the issuer satisfied the standards set forth in relevant administrative and judicial interpretations at the time of the offering but the issuer would have the burden of proving the availability of the exemption. Rule 147 relates to transactions exempted from the registration requirements of Section 5 of the Act by Section 3(a)(11). Neither the rule nor Section 3(a)(11) provides an exemption from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934, the anti-fraud provisions of the federal securities laws, the civil liability provisions of Section 12(2) of the Act or other provisions of the federal securities laws.

Finally, in view of the objectives of the rule and the purposes and policies underlying the Act, the rule shall not be available to any person with respect to any offering which, although in technical compliance with the rule, is part of a plan or scheme by such person to make interstate offers or sales of securities. In such cases registration pursuant to the Act is required.

4. The rule provides an exemption for offers and sales by the issuer *only*. It is not available for offers or sales of securities by other persons. Section 3(a)(11) of the Act has been interpreted to permit offers and sales by persons controlling the issuer, if the exemption provided by that Section would have been available to the issuer at the time of the offering. See Securities Act Release No. 4434 (December 6, 1961). Controlling persons who want to offer or sell securities pursuant to Section 3(a)(11)

may continue to do so in accordance with applicable judicial and administrative interpretations.

The text of the rule follows:

(a) *Transactions Covered.*

Offers, offers to sell, offers for sale and sales by an issuer of its securities made in accordance with all of the terms and conditions of this rule shall be deemed to be part of an issue offered and sold only to persons resident within a single state or territory where the issuer is a person resident and doing business within such state or territory, within the meaning of Section 3(a)(11) of the Act.

(b) *Part of an Issue.*

(1) For purposes of this rule, all securities of the issuer which are part of an issue shall be offered, offered for sale or sold in accordance with all of the terms and conditions of this rule.

(2) For purposes of this rule only, an issue shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by Section 3 or Section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule, *provided that*, there are during either of said six month periods no offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

NOTE: In the event that securities of the same or similar class as those offered pursuant to the rule are offered, offered for sale or sold less than six months prior to or subsequent to any offer, offer for sale or sale pursuant to this rule, see Preliminary Note 3, hereof as to which offers, offers to sell, offers for sale, or sales are part of an issue.

(c) *Nature of the Issuer.*

The issuer of the securities shall at the time of any offers and the sales be a person resident and doing business within the state or territory in which all of the offers, offers to sell, offers for sale and sales are made.

(1) The issuer shall be deemed to be a resident of the state or territory in which:

(i) it is incorporated or organized, if a corporation, limited partnership, trust or other form of business organization that is organized under state or territorial law;

(ii) its principal office is located, if a general partnership or other form of business organization that is not organized under any state or territorial law;

(iii) his principal residence is located, if an individual.

(2) The issuer shall be deemed to be doing business within a state or territory if:

(i) the issuer derived at least 80% of its gross revenues and those of its subsidiaries on a consolidated basis

(A) for its most recent fiscal year, if the first offer of any part of the issue is made during the first six months of the issuer's current fiscal year; or

(B) for the first six months of its current fiscal year or during the twelve month fiscal period ending with such six month period, if the first offer of any part of the issue is made during the last six months of the issuer's current fiscal year

from the operation of a business or of real property located in or from the rendering of services within such state or territory; provided, however, that this provision does not apply to any issuer which has not had gross revenues in excess of \$5,000 from the sale of products or services or other conduct of its business for its most recent twelve month fiscal period;

(ii) the issuer had at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue, at least 80 percent of its assets and those of its subsidiaries on a consolidated basis located within such state or territory;

(iii) the issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to this rule in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory; and

(iv) the principal office of the issuer is located within such state or territory.

(d) *Offerees and Purchasers: Person Resident.*

Offers, offers to sell, offers for sale and sales of securities that are part of an issue shall be made only to persons resident within the state or territory of which the issuer is a resident. For purposes of determining the residence of offerees and purchasers:

(1) A corporation, partnership, trust or other form of business organization shall be deemed to be a resident of a state or territory if, at the time of the offer and sale to it, it has its principal office within such state or territory.

(2) An individual shall be deemed to be a resident of a state or territory if such individual has, at the time of the offer and sale to him, his principal residence in the state or territory.

(3) A corporation, partnership, trust or other form of business organization which is organized for the specific purpose of acquiring part of an issue offered pursuant to this rule shall be deemed not to be a resident of a state or territory

unless all of the beneficial owners of such organization are residents of such state or territory.

(e) *Limitation of Resales.*

During the period in which securities that are part of an issue are being offered and sold by the issuer, and for a period of nine months from the date of the last sale by the issuer of such securities, all resales of any part of the issue, by any person, shall be made only to persons resident within such state or territory.

NOTES:

1. In the case of convertible securities resales of either the convertible security, or if it is converted, the underlying security, could be made during the period described in paragraph (e) only to persons resident within such state or territory. For purposes of this rule a conversion in reliance on Section 3(a)(9) of the Act does not begin a new period.
2. Dealers must satisfy the requirements of Rule 15c2-11 under the Securities Exchange Act of 1934 prior to publishing any quotation for a security, or submitting any quotation for publication, in any quotation medium.

(f) *Precautions Against Interstate Offers and Sales.*

(1) The issuer shall, in connection with any securities sold by it pursuant to this rule:

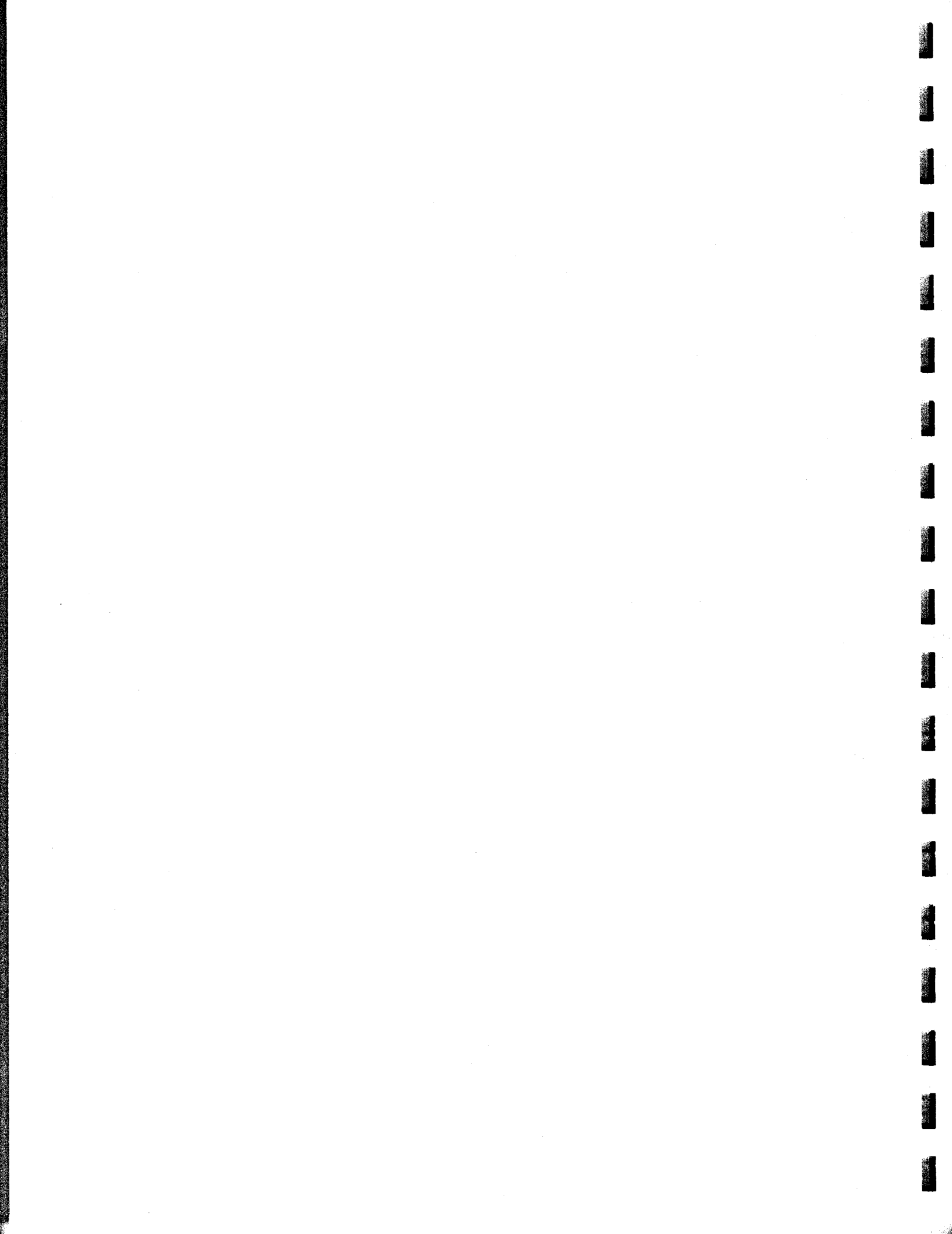
(i) place a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the Act and setting forth the limitations on resale contained in paragraph (e);

(ii) issue stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, make a notation in the appropriate records of the issuer; and

(iii) obtain a written representation from each purchaser as to his residence.

(2) The issuer shall, in connection with the issuance of new certificates for any of the securities that are part of the same issue that are presented for transfer during the time period specified in paragraph (e), take the steps required by subsections (f)(1)(i) and (ii).

(3) The issuer shall, in connection with any offers, offers to sell, offers for sale or sales by it pursuant to this rule, disclose, in writing, the limitations on resale contained in paragraph (e) and the provisions of subsections (f)(1)(i) and (ii) and subparagraph (f)(2).

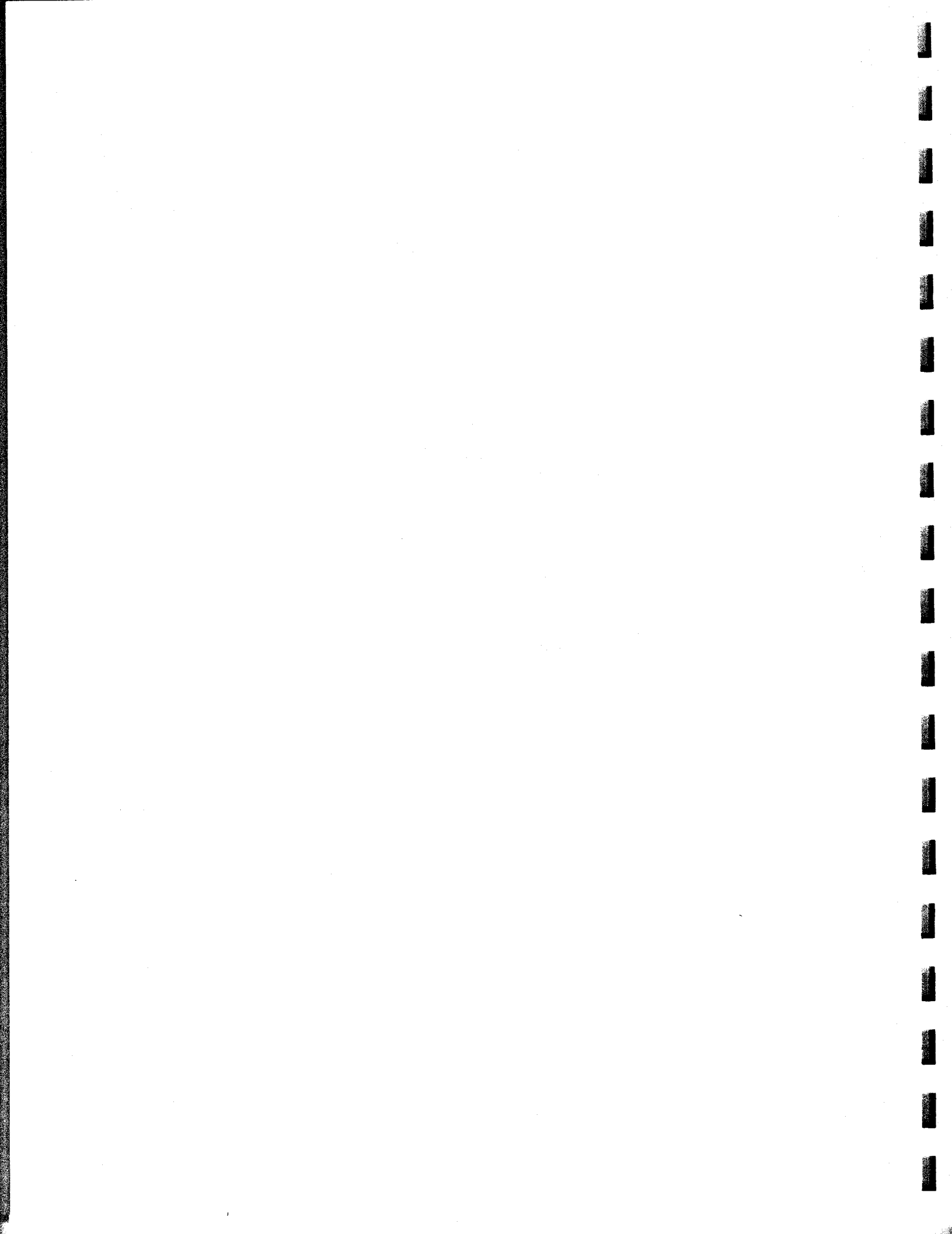


STATE BLUE SKY EXEMPTIONS:
COORDINATING KENTUCKY EXEMPTIONS
WITH REGULATION D AND
INTRASTATE OFFERINGS

Garrison R. Cox
Ogden and Robertson
Louisville, Kentucky

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SECTION J



STATE BLUE SKY EXEMPTIONS
COORDINATING KENTUCKY EXEMPTIONS
WITH REGULATION D AND
INTRASTATE OFFERINGS

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**STATE BLUE SKY EXEMPTIONS:
COORDINATING KENTUCKY EXEMPTIONS WITH
REGULATION D AND INTRASTATE OFFERINGS**

**Garrison R. Cox
Ogden & Robertson
Louisville, Kentucky**

Preliminary Notes:

Many lawyers pride themselves on their ability to "do deals" which involve forming a corporation or limited partnership, without ever considering the constraints which state securities laws place on those entities' issue of securities and on their later transfer by initial holders. This is too bad, because violating most states' securities laws can lead not only to required rescission offers but also to civil and criminal penalties if the violations are flagrant enough.

Fortunately for those lawyers, their clients, and their malpractice carriers, investors don't complain while their investments are performing well. But as last October's stock market crash demonstrated in an unforgettable way, even "blue chip" investments don't always perform well. In the current investment environment, it is even more critical for you to know that the issuer you represent either registered its securities or qualified them properly for exemptions from registration in every relevant jurisdiction and made adequate disclosure to the investors on the front end.

This outline focuses on Kentucky's blue sky law, with a glance at other states' laws in section II. Its aim is to give you an understanding of exemptions from securities registration rather than the registration process itself (but that too is covered lightly in section I.D.). All federal and Kentucky statutes and regulations referred to below are reproduced elsewhere in the study materials containing this outline. Other states' statutes and regulations can be found in CCH Blue Sky Reporter, a four-volume service.

I. THE SECURITIES REGULATION/EXEMPTION SCHEME IN KENTUCKY
(in ascending order of compliance difficulty)

Kentucky's blue sky law is found in KRS Chapter 292 and in 808 KAR Chapter 10. The statutes are based largely on the 1956 Uniform Securities Act; the General Assembly did not consider adopting the 1985 Uniform Securities Act in its 1986 session, and is not likely to do so in its 1988 session. No significant case law has developed under Chapter 292. If you have a question about a particular state statute or regulation, contact the Division of Securities at (502) 564-2180; the staff there is eager to help. You can get a written interpretive opinion under KRS 292.420(3) if you send the Division a request for a ruling, a verified statement of your facts, and a check for \$100 payable to the Kentucky State Treasurer.

A. Self-Operating "Organizers" Exemption

1. Generally: 808 KAR 10:150 Section 1.(1), promulgated under KRS 292.410(1)(q), provides a self-operating exemption for "small business organizations" with ten or fewer "organizers." Called the "organizers exemption," this is the exemption from registration most corporations inadvertently qualify for. Although the regulation is fairly straightforward, it does have some restrictions:

- a. The "organizers" must be organizing a corporation, joint venture, or similar business organization other than a limited partnership and other than an oil, gas, or mineral interest.
- b. The issuer can contact no more than 25 offerees (you can increase this number to 50 or more on written request to the Division of Securities).
- c. Each buyer must meet three tests:
 - (1) The buyer must be an "organizer" on the date the issuer is formed. In a 1982 letter, the Director of the Division of Securities offered some guidance on who an "organizer" might be:

To be an organizer one does not have to be an incorporator. Neither does one have to be the originator or among the first individuals to discuss the general idea. It is sufficient that one be a part of the group during the final planning stages of the organization with sufficient understanding of the plan (either alone or through an agent) to make meaningful input and to make the decision as to whether or not to participate in the final product.

Exactly how one "participates in a final product" is left to the imagination. Timing is also somewhat vague here: assuming other conditions are met, one who invests one day after the initial shareholders is pretty clearly an "organizer"; query whether six months later is always too late?

(2) The buyer must buy with "investment intent" as defined in 808 KAR 10:160 Section 1.(2) -- basically, the intent to hold the security for at least two years.

(3) Finally, the buyer must have access to information concerning the issuer (an odd requirement for an organizer, but there it is).

d. In connection with the organization, no commission or other remuneration can be paid or given directly or indirectly to any person for soliciting any Kentucky offeree.

e. No public advertising can be used in offering or selling the securities.

2. Coordination with Federal Exemptions: For an offering of a significant size, arranging for ten or fewer organizers to supply all the needed cash is difficult at best. Therefore, this exemption is not a likely option to consider when planning an offering exempt under federal Regulation D or the intrastate exemption. Practically, however, the general exemption provided by Securities Act § 4(2) and the intrastate exemption in § 3(a)(11) are also self-operating, and one or the other is likely to be met in all offerings which qualify for the Kentucky "organizers" exemption.

B. Limited Offering Exemption

1. Generally: Kentucky's next most available exemption is the limited offering exemption under KRS 292.410(1)(i), as amplified by KRS 292.415 and 808 KAR 10:190 Section 1.(1). It is based on the Uniform Securities Act, and many other states have a similar provision.

Although not too tough to comply with, this exemption is not well known among general practitioners and is commonly ignored. Penalties for not securing this exemption include a mandatory rescission offer and a \$500 penalty, however.

The salient features of this exemption include:

a. a filing fee of \$100 (payable to the Kentucky State Treasurer);

- b. a limit on the number of offerees (not just buyers) to 25, whether or not located in Kentucky (but this limit can be raised to 50 or higher on written request to the Division of Securities);
 - c. an offering circular or placement memorandum, a copy of which is to be filed (note that the Division of Securities may waive this requirement if you can show that all offerees have access to information about the issuer);
 - d. "investment intent" letters to be signed by investors, stating that they are buying for investment (at least two years -- see definition in 808 KAR 10:160 Section 1.(2));
 - e. "current financial statements" of the issuer being made public (see 808 KAR 10:160 Section 1.(1) for the definition of "current financial statements");
 - f. a waiting period of ten business days -- at least two weeks -- from receipt by the Division of Securities, which is generally quite strict about this;
 - g. no public advertising is allowed; and
 - h. an effective period of twelve months, unless extended by the Division of Securities.
2. Sample Filing: Exhibit 1 to this outline includes a letter claiming the 292.410(1)(i) exemption and some of its attachments: an investment intent letter, a restrictive legend, and a sample certificate. The entire filing package included articles of incorporation, by-laws, audited financial statements, an auditor's letter, and a \$100 check made payable to the Kentucky State Treasurer.
3. Coordination with the Intrastate Exemption: The federal intrastate exemption dovetails nicely with the Kentucky limited offering exemption. That was exactly Congress' intent in adopting the intrastate exemption -- some issues of securities are of little concern to the federal government, and the states are free to regulate or exempt them as they see fit.
- Because the intrastate exemption (whether under § 3(a)(11) or under Rule 147) is self-operating, the limited offering exemption of KRS 292.410(1)(i) is actually more burdensome to comply with than the federal exemption. The most annoying compliance problem (after preparing the disclosure document) is the two-week delay after filing.
4. Coordination with Regulation D, Rule 504: Unlike some states' securities laws, Kentucky's do not coordinate with the federal exemption under Regulation D at the 504

(under \$500,000) level. Therefore, even if you have met all the requirements of Rules 501-504 of Regulation D, you must still jump through the hoops of the limited offering exemption. This means that, even though Rule 504 has no minimum information requirements and no limit on the number of non-accredited investors, you are stuck with the disclosure requirements set out above and at most, 50 offerees (absent some unusual circumstances). These restrictions have caused some deals that meet 504 to be restructured to meet 505 or 506 instead.

C. Coordination with Regulation D Rules 505 and 506

1. Generally: Like most states, Kentucky has attempted to coordinate with the federal exemptions from registration provided by Rules 505 and 506 in Regulation D. This coordination has taken place largely through the adoption of the Uniform Limited Offering Exemption ("ULOE"), proposed by the North American Association of Securities Administrators before Regulation D was adopted.
2. Kentucky's ULOE Provisions: Kentucky's coordinating provisions appear in 808 KAR 10:210. Aside from filing a copy of the federal Form D with the Division of Securities within 15 days of the initial sale under Rule 505 or 506, the issuer must observe several other requirements:
 - a. Commissions can be paid only to broker-dealers registered in Kentucky.
 - b. No controlling person (director, officer, general partner, 10% shareholder, promoter, or underwriter) can be a "bad boy" as defined in 808 KAR 10:210 Section 1.(1)(b). Note that these "bad boy" provisions apply whether the offering is under Rule 505 or 506, unlike the federal analog.
 - c. Sales are limited to 35 or fewer non-accredited investors (plus an unlimited number of accredited investors).
 - d. In addition to filing the Form D, issuers must file a copy of any offering materials or other information provided to potential investors, and update that material if necessary.
 - e. Non-accredited investors must meet both an objective suitability test (the investment must not exceed 10% of his or her net worth (no exclusions -- cf. federal exclusions)) and a subjective suitability test (smart enough, alone or with buyer representative, to evaluate the merits and risk of the investment).

D. Registration

1. **Generally:** Registration at the state level is not often considered in the context of exempt offerings, but sometimes it is the only way to get a deal sold. If, for example, you are relying on the intrastate exemption at the federal level but need to make offers to more than 50 Kentucky residents, the limited offering exemption provided by KRS 292.410(1)(i) is not available. Or, if you have decided to use the quasi-registration provisions of Regulation A, you will already have done most of the work necessary to get an offering registered by qualification in Kentucky, and you may as well do so and enjoy the benefits of having resales covered.
2. **Requirements:** The requirements for registration by qualification are set out in KRS 292.370 and .380. They are very similar to the requirements of Part I of the federal Form S-18, which is the basis for disclosure for offerings under Rules 505 and 506 which include non-accredited investors.

The registration statutes will not be considered in more detail here. Keep the option in mind, however, when you have a deal that fits a federal exemption but no state exemption.

II. REGISTRATION EXEMPTIONS IN OTHER STATES

Fortunately, 36 other jurisdictions have also adopted, in whole or in part, the Uniform Securities Act of 1956, so there is a degree of predictability among states. Unfortunately, even these states have more variation in their exemptions than in their registration requirements.

A. Isolated Transaction Exemption

Often, your client will want to make only a few offers or sales in a state outside Kentucky. The first thing to look for is an "isolated transaction exemption" for that state. If available to issuers (many, like Kentucky's, are not), the exemption is self-operating and can save a lot of effort in trying to coordinate with Regulation D.

B. Analogues to Kentucky "Organizers" Exemption

The next thing to look for is an "organizers" exemption, if your issuer is in that stage. These vary greatly from state to state, but are usually self-operating if they exist.

C. Direct Coordination with Regulation D Rule 504

Ten jurisdictions (Colorado, Delaware, D.C., Indiana [limited to 35 buyers, only 15 of whom can be Hoosiers], Nevada, New Jersey, New York, Oklahoma, Oregon, and Washington) exempt 504 offerings, usually only with a filing of the Form D and a copy of any offering material. Very handy when available. Unlike Rule 503, however, some of these jurisdictions have filing requirements either before offers or before sales (Indiana and Oklahoma, ten business days before

a sale; New York and Oregon, filing before offer; Washington, ten business days before offer or sale).

D. Indirect Coordination with Regulation D Rule 504

As indicated above, many other jurisdictions have adopted the Uniform Securities Act of 1956 in some form, and therefore have a limited offering exemption similar to Kentucky's (limited in number of offerees, use of advertising, commissions to other than registered broker-dealers, etc.) Most require advance filing, sometimes on a specific form, sometimes days in advance of offers. The trick is to establish the availability or non-availability of other exemptions soon enough to claim the limited exemption before your client starts making sales calls.

E. Coordination with Regulation D Rules 505 and 506

Kentucky and 22 other jurisdictions coordinate more or less directly with exemptions under both Rules 505 and 506; another ten states exempt only Rule 506 offerings. Note that states change their securities laws, especially in this area, with some frequency. The best bet is to consult a recent source (see bibliography in appendix) for the most recent rules and try to coordinate as much as possible with your exemption. A bright paralegal with a good tickler file can be invaluable with this exercise if you find yourself involved with more than a handful of jurisdictions.

Particularly quirky states include California, New York, Oregon, Tennessee, and Texas -- you may even want to retain local counsel in these jurisdictions.

F. Registration

It isn't much fun, but sometimes it is the only route available. Often, the expense of registration will simply rule out a certain jurisdiction if no obvious exemption is available. Most states' requirements for registration by qualification will parallel Kentucky's.

III. TRAPS FOR THE UNWARY

Orchestrating exemptions in more than one state can be complicated enough. You should, however, be aware that some states have requirements buried in their statutes or regulations far from the discussion of exemptions from registration. Only a few of the most pernicious are addressed briefly below.

A. Unique Restrictive Legends

Nineteen states (including Indiana) require specific legends on disclosure documents, indicating that the offer and sale have not been approved by their securities commissions, that rescission may be available under certain circumstances, and other limits. Your inside front page of an offering memo may contain several paragraphs addressed to offerees of specific states to cover all these bases.

B. Projections in Pennsylvania

Pennsylvania has very strict rules on the use of financial forecasts and projections in offering materials, requiring an "independent person" (CPA) to review them under some circumstances; this statute was recently relaxed somewhat. See 2 Blue Sky L. Rep. (CCH) ¶ 48,585. If you do not do this in advance, the Pennsylvania Securities Commission will get first excited, then ugly. To avoid this, some counsel will prepare a separate disclosure document for Pennsylvania offerees, omitting projections.

C. Unusual Counting Rules

California, Indiana, Kentucky, and Tennessee, among others, are states with a parochial (some say unconstitutionally broad) view of how offerees or buyers must be counted; they apply their total limits outside their boundaries, either in their limited offering exemptions or in their efforts to coordinate with Regulation D. Pay attention here.

IV. HOPE FOR THE HOPELESS

Sometimes, your client comes to you after offers or sales have already been made all over Creation. Sometimes, your paralegal disappears in mid-offering and you can't figure out what is allowed where. Don't panic. Before ordering your client to make a rescission offer and calling your malpractice insurer, consider the suggestions under II.A. and B. above (for other states) and these Kentucky exemptions as possible ways out:

A. **Professional Service Corporations:** Any security issued by a professional service corporation organized under KRS Chapter 274 or substantially similar legislation of another state is exempt from registration in Kentucky.

B. **Special Cases:** If the issuer is an unusual entity such as a rural electric cooperative, a credit union, or a charitable or religious organization, check the securities exemptions under KRS 292.400 and their correlative regulations.

C. **Seasoned Issuers:** You may occasionally represent a reporting company (under the 1934 Act) with more than 1200 shareholders. If so, check KRS 292.400(14), 292.415, and 808 KAR 10:170 for this exemption. Although it may be slightly more cumbersome than Regulation D compliance at the state level, you do wind up with exempt securities without having to worry about future resales.

D. **Resales:** KRS 292.410(1)(a) exempts isolated non-issuer transactions.

If none of the above is available, you may be faced with making a rescission offer to any subscribers who have already sent in cash. This is unpleasant, but can be done without killing the deal if the error is caught soon enough. If it can't, cheer up. The statute of limitations on securities actions in Kentucky is three years after the sale. KRS 292.480(3).

OGDEN & ROBERTSON

1200 ONE RIVERFRONT PLAZA
LOUISVILLE, KENTUCKY 40202-2938

RICHARD F. NEWELL
JAMES S. WELCH
JOHN T. BALLANTINE
JOSEPH C. OLDHAM
STEPHEN F. SCHUSTER
SCOTT T. WENDLSDORF
ERNEST W. WILLIAMS
GERALD R. TONER
WALTER LAPP SALIS
DAVID A. HARRIS
STEPHEN A. WATKINS

GREGORY J. BURALO*
ROBERT R. SABLINGER
GARRISON R. COX
D. BRIAN RUTLUFF
WILLIAM A. BARTH
W. GREGORY KING
JAMES N. G. CAUTHEN
ROBERT E. THEAMAN
ANN K. BINFIELD
THOMAS V. KENNEDY
LISA ANN VOOT

Telephone & Telecopier
(502) 582-1601
Telex: 5106018109

SQUIRE R. OGDEN (1898-1984)

OF COUNSEL
CHARLES A. ROBERTSON

January 9, 1987

* ALSO ADMITTED INDIANA

Ms. Ronda Paul, Director
Division of Securities of
the Department of Financial
911 Leawood Drive
Frankfort, KY 40601

**Issuance of Eighty Shares of Common Stock of
Allied Tools & Supply Co., Inc.**

Dear Ms. Paul:

The above issuer plans to issue 80 shares of its common stock pursuant to the Kentucky limited offering exemption. Pursuant to KRS 292.410(1)(i), KRS 292.415, and 808 KAR 10:190, and on the behalf of the above mentioned issuer the undersigned does hereby declare:

- (1) that the offer to sell the shares in question will not be made to more than 25 people in the Commonwealth of Kentucky during the period of 12 months from the effective date of the exemption;
- (2) that no commission or other remuneration will be paid or given directly or indirectly for soliciting any prospective buyer in this state;
- (3) that the Seller believes the buyers in this state are purchasing for investment and that said buyers will sign a copy of an investment intent letter (a copy of which is attached);
- (4) that the securities will be issued with an appropriate restrictive legend (a copy of which is attached);
- (5) that offerees and purchasers of the securities shall have access to information concerning the issuer; and
- (6) that no public advertising or solicitation has been employed in effecting the transaction.

Ronda Paul
January 9, 1986
Page 2

As required by 808 KAR 10:190 the following documents and information have been attached in addition to those mentioned in (3) and (4) above:

- (a) Articles of Incorporation and Bylaws.
- (b) Current compiled financial statements of the issuer. The issuer does not have audited financials.
- (c) There is no offering circular. The issuer will offer its shares to one offeree, an existing shareholder with open access to the issuer's financial information. Therefore, the issuer requests a waiver of this requirement. If you need further information before granting this waiver, please contact the undersigned.
- (d) Sample stock certificate.

I have enclosed a \$100 check made payable to the Kentucky State Treasurer for filing fees. Thank you for your cooperation.

Very truly yours,

Jeanne R. Clemens

JRC/dm
Enclosures

January __, 1987

Allied Tools & Supply Co., Inc.
3901 Bishop Lane
Louisville, KY 40218

Re: Purchase of Shares

The undersigned hereby agrees to purchase ___ shares of
Common Stock of Allied Tools & Supply Co., Inc.

Purchaser agrees that the shares being purchased are
being purchased for investment with no present intention of
reselling or redeeming said shares. Purchaser intends to hold
said shares for at least two years.

Purchase agreed to
ALLIED TOOLS & SUPPLY CO., INC.

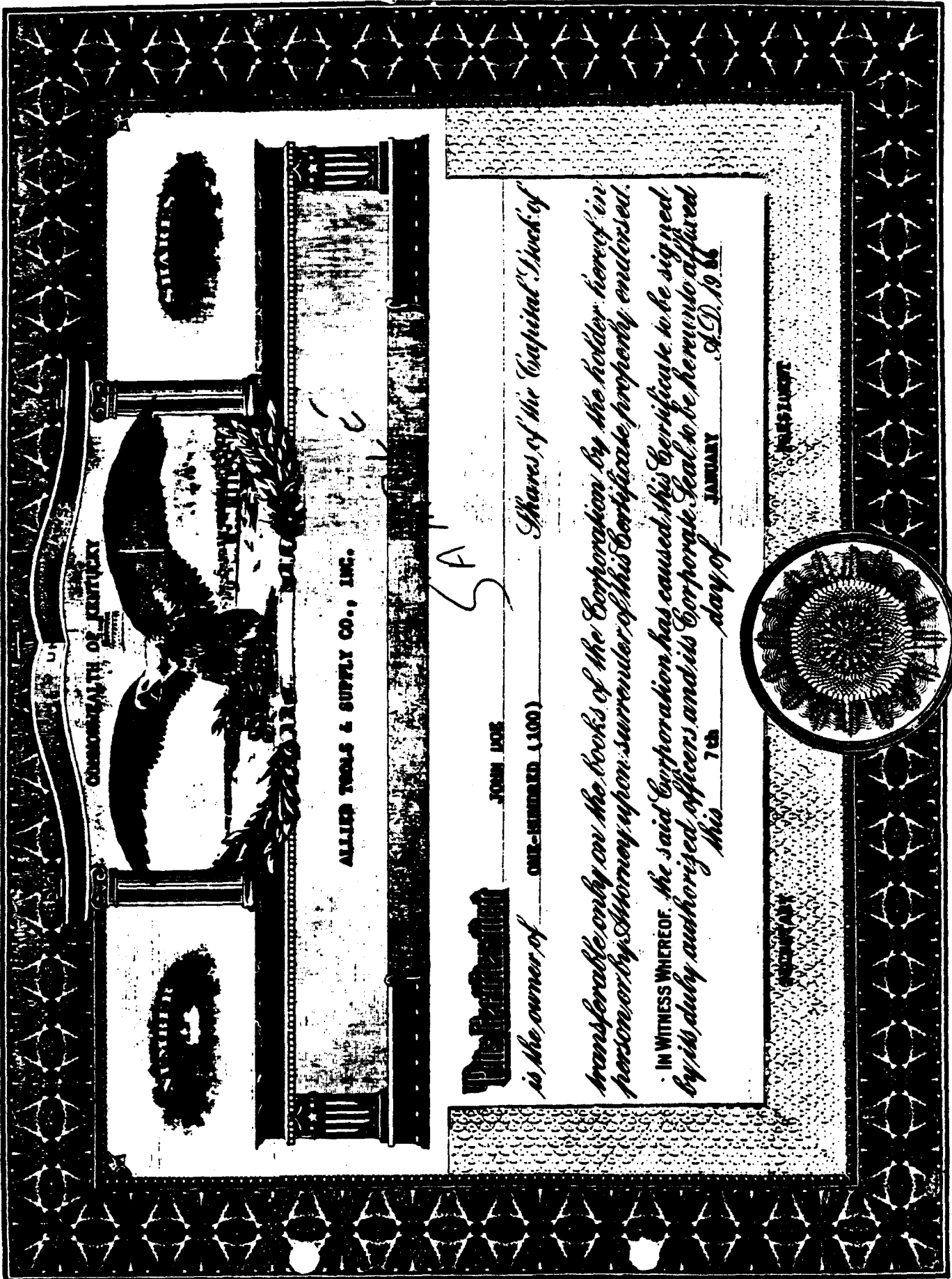
By: _____
(Authorized Officer)

Date: January __, 1987

RESTRICTIVE LEGEND FOR ALLIES STOCK CERTIFICATE:

THIS STOCK HAS NOT BEEN REGISTERED WITH EITHER THE FEDERAL SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION. IT MAY NOT BE TRANSFERRED UNLESS SO REGISTERED, OR UNLESS AN EXEMPTION FROM REGISTRATION IS AVAILABLE UNDER BOTH FEDERAL AND STATE SECURITIES LAWS.

SAMPLE



COMMONWEALTH OF MASSACHUSETTS

ALLIED TOOLS & SUPPLY CO., INC.

Notarized

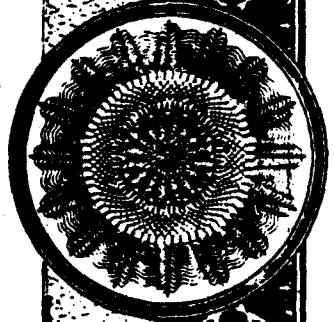
JOHN JOE

ONE-HUNDRED (100)

is the owner of SA Shares of the Capital Stock of

transferable only on the books of the Corporation by the holder hereof in person or by Attorney upon surrender of this Certificate, properly endorsed.

IN WITNESS WHEREOF, the said Corporation has caused this Certificate to be signed by its duly authorized officers and its Corporate Seal to be hereunto affixed this 7th day of JANUARY A.D. 19 26

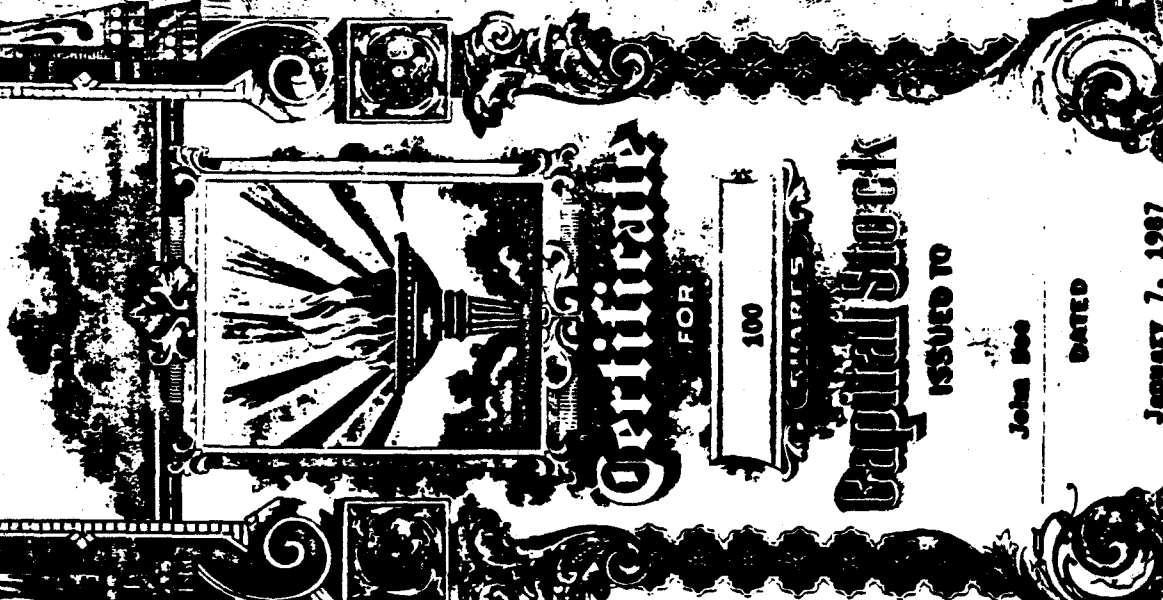


© 1911 - 284

SAMPLE

SAMPLE

THIS STOCK HAS NOT BEEN REGISTERED WITH EITHER THE FEDERAL SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION. IT MAY NOT BE TRANSFERRED UNLESS SO REGISTERED, OR UNLESS AN EXEMPTION FROM REGISTRATION IS AVAILABLE UNDER BOTH FEDERAL AND STATE SECURITIES LAWS.



For Value Received, hereby sold, assign, and transfer unto

_____ Shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint _____ to transfer the said Stock, on the books of the within named Corporation with full power of substitution in the premises.

*Dated _____ 19____
In presence of _____*

NOTICE: THE SIGNATURE OF THE ISSUING OFFICER OF THE CAPITAL STOCK IS NECESSARY TO VALIDATE THIS CERTIFICATE. THE SIGNATURE OF THE ISSUING OFFICER OF THE CAPITAL STOCK IS NECESSARY TO VALIDATE THIS CERTIFICATE.

UNDERSTANDING INTERRELATIONSHIPS
BETWEEN TYPES OF EXEMPT OFFERINGS

- .Regulation D
- .Intrastate Exemption
- .Blue Sky Exemptions

AND THEIR APPLICATION TO VARYING CLIENT NEEDS

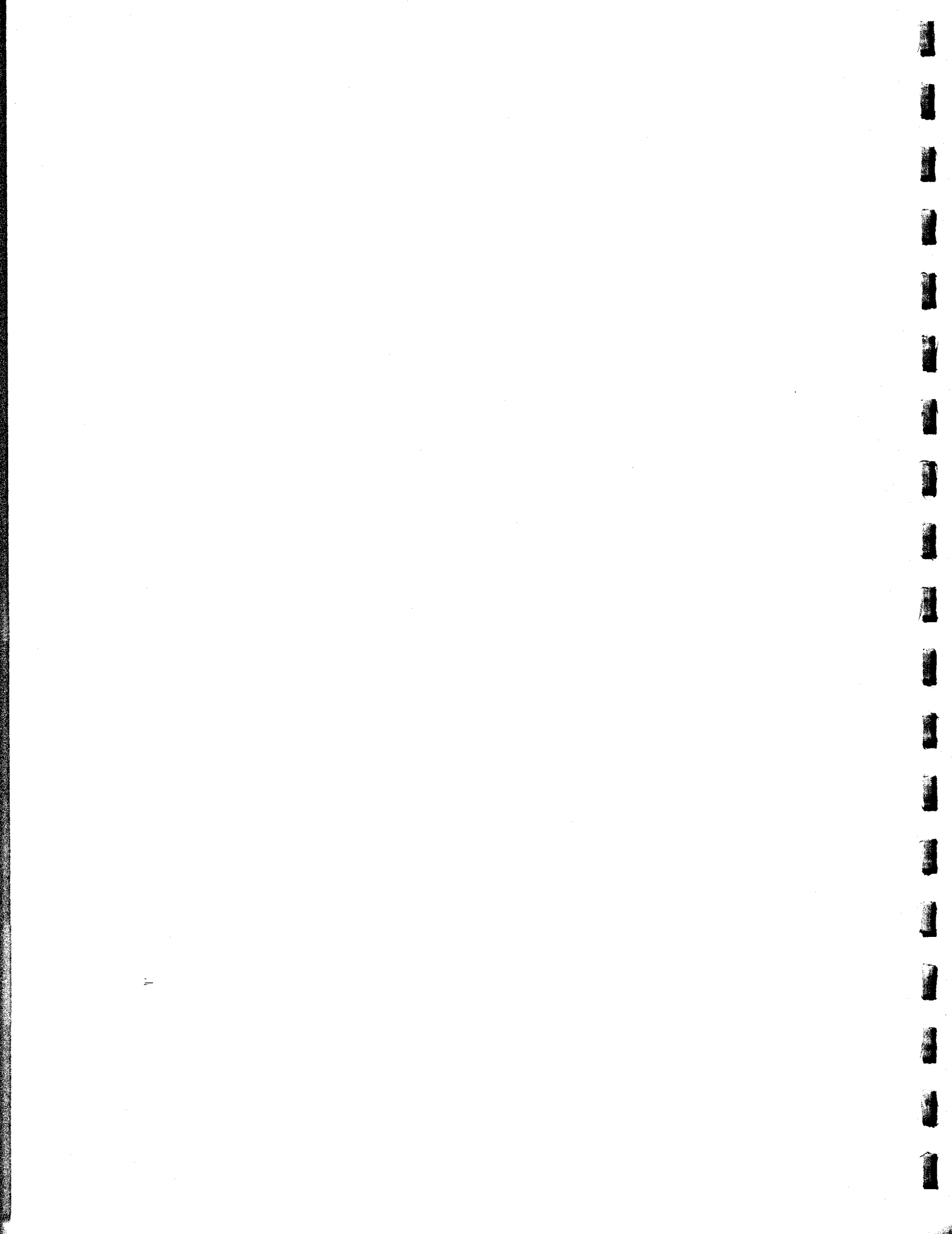
Panel Presentation

David W. Harper
Hirn Reed Harper and Sisinger, Louisville, KY.

Gary L. Stage
Stoll, Keenon and Park, Lexington, KY

Garrison R. Cox
Ogden and Robertson, Louisville, KY

SECTION K



PANEL PRESENTATION: "AVENUES TO EXEMPT OFFERINGS"

PANEL MEMBERS:

**David W. Harper
Hirn Reed Harper & Eisinger, Louisville**

**Gary L. Stage
Stoll, Keenon & Park, Lexington**

**Garrison R. Cox
Ogden & Robertson, Louisville**

7TH ANNUAL SEMINAR ON SECURITIES LAW

**University of Kentucky
College of Law
Office of Continuing Legal Education**

**Hyatt Regency Lexington
Saturday, February 13, 1988**

PANEL PRESENTATION:

AVENUES TO EXEMPT OFFERINGS

The panel will present a multi-part hypothetical, following the development of a new company from its start-up stage through several financings. Exemptions are presented in order of complexity.

Preliminary notes:

1. Every offer and sale of a security must either take place under an effective registration statement or qualify for an exemption from registration in every jurisdiction (usually, federal and one or more states) in which offers or sales of the security are made. Because registration is complicated and expensive, the vast majority of transactions in securities take place under various federal and state exemptions.
2. Exempt securities are exempt because of their status, which is usually related to the nature of their issuers (such as governments or financial institutions). Exempt transactions are valid only for the transactions themselves -- any subsequent disposition of a security acquired in an exempt transaction must itself be either registered or exempted from registration. Almost all of the exemptions considered below are for exempt transactions.
3. The panel is discussing exemptions from registration only. There are no exemptions from federal or state antifraud liability.

I. Avoiding the Registration Question Altogether -- No Security

Fact Situation 1: Three Kentuckians, Harper, Stage, & Cox, want to start a business providing paralegal services on a contract basis to attorneys or law firms who need temporary paralegal help. Harper will do the financing, Stage the recruiting and marketing, and Cox the "back office." Each will contribute \$10,000 in capital and office furnishings.

How can they organize the business to eliminate securities problems? Here, the obvious choice is to form a general partnership. Based on these facts, Harper, Stage, and Cox will be forming a "true" general partnership, and not a disguised limited partnership, where one or more investors has no control of the business' operations. Interests in "true" general partnerships are not securities, so counsel need not be concerned with compliance with either federal or state securities laws. (Substance will prevail over form here, so do not try to disguise a limited partnership as a general partnership just to avoid securities law issues.)

II. Taking Advantage of Self-Operating Exemptions

Fact Situation 2: Same as in Fact Situation 1, except Harper, Stage, and Cox want to form a Kentucky corporation (probably an S corporation for tax reasons), "Legal Eaglets, Inc." and issue common stock to themselves.

A. Federal Registration Exemptions

1. Section 3(a)(11) Intrastate Offering and Rule 147: The most tempting choice here is to rely on the exemption provided by Securities Act § 3(a)(11) for intrastate offers and sales, but it is not risk-free. See Appendix L1-3, Appendix L2, and the outline on the intrastate exemption in the bound outline. Many transactions fit this exemption without counsel's recognizing that federal securities apply to them.
2. Section 4(2) Not Involving Public Offering: While Regulation D is not a self-operating "safe harbor" for complying with Securities Act § 4(2), the harbor is narrower than the ocean, and it is possible to issue stock under the judicial and administrative interpretations of § 4(2) without a filing. This involves an inquiry into the offerees' sophistication and access to information.
3. Resales: Rule 144 will govern resales of stock in Legal Eaglets, Inc.: unless the corporation ultimately meets the "public information" requirements of Rule 144(c) (which is unlikely at this point), Harper, Stage, and Cox will have to hold their stock for at least 3 years and sell it 3 months after they are no longer affiliates. Rule 144(k). Another possibility is to comply with "§ 4(1-1/2)." See the outline materials on Resales of Securities and *The Section "4(1-1/2)" Phenomenon: Private Resales of "Restricted" Securities*, 34 Business Lawyer 1961 (1979). Resales of § 3(a)(11)/ Rule 147 stock must, for the first nine months after issue, be to Kentucky residents only. Rule 147(e).

B. Kentucky Registration Exemption

1. The "Organizers" Exemption: 808 KAR 10:150 Section 1.(1) (Appendix L5-1), promulgated under KRS 292.410 (1)(q) (Appendix L3-6), provides a self-operating exemption for "small business organizations" with ten or fewer "organizers." This exemption is not available to limited partnerships.
2. Resales: KRS 292.410(1)(a) (Appendix L3-4) exempts isolated non-issuer transactions, as long as the securities have been held for at least two years. This is due to a requirement of the organizers exemption that organizers buy with "investment intent." See 808 KAR 10:150 Section 1.(1)(c) and 10:160 Section 1.(2) (Appendix L5).

3. Reclassification: Note that, if a partnership had been formed before the three principals decided to incorporate, the reclassification into a corporation could be exempted from registration under KRS 292.410(1)(n) (Appendix L3-6), according to a 1982 no-action letter from the Division of Securities. This exemption appears to be self-operating, and would probably be available even if there were more than ten general partners at the time of conversion.

III. When Self-Operating Exemption Is Not Available

Fact Situation 3: Legal Eaglets, Inc. has been doing fairly well for six months, but needs a capital infusion if it is going to reach Harper's aggressive goals for growth in the next year. Local banks (and local branches of interstate banks) are not impressed by the business' prospects, so the three owner/investors are considering either (a) selling up to \$500,000 in stock to some other investors, or (b) forming a limited partnership with Legal Eaglets, Inc. as the general partner and limited partners providing the additional capital.

A. Federal Registration Exemptions

1. Section 3(a)(11) Intrastate Offering and Rule 147: This exemption could work again here, depending on the number and domicile of potential offerees. If any offerees are domiciled outside Kentucky, this exemption is not available -- a serious problem in states with a limited number of likely investors. (Note that S corporations face limits on the types and number of persons who can invest; check current tax law on this issue.)
2. Rule 504 under Regulation D: This is the logical choice. The exemption is provided for in Securities Act § 3(b) (Appendix L1-3), and fleshed out in Regulation D. One nice feature of Rule 504 is that it has no limit on the number of offerees or purchasers (Kentucky does, however). Another is that the rule has no specific information requirements for investors, whether "accredited" or not; like Rule 147, Rule 504 does not, however, exempt an issuer or its affiliates from the antifraud provisions of the 1933 or 1934 Acts -- so disclosure is critical. The only thing filed with the SEC is a Form D, filed within 15 days of the first sale.
3. Resales: Again, resales under either route would be subject to Rule 144. Limited partnership interests will usually have additional or different restrictions on resale imposed by the limited partnership agreement itself.

B. Kentucky Registration Exemption

1. Limited Offering Exemption: Because the "organizers" exemption is available only to "organizers," investors coming in six months after a corporation was formed would be very unlikely to fit in this category. The next most likely available exemption is the limited offering exemption under KRS 292.410(1)(i) (Appendix L3-5), as amplified by KRS 292.415 (Appendix L3-8) and 808 KAR 10:190 Section 1.(1) (Appendix L5-5 to L5-6). Although not too tough to comply with, this exemption is not well known among non-securities lawyers and is therefore commonly ignored. Penalties for not securing this exemption can, however, include a mandatory rescission offer and a \$500 penalty. See the outline on State Blue Sky Exemptions for details on claiming this exemption.

IV. Exemptions for Maturing Business Needing More Capital

Fact Situation 4: As it happens, Legal Eaglets, Inc. starts its business just as law firms come to recognize that they cannot afford the starting salaries of competent new law school graduates; demand for its paralegal services skyrockets. Eighteen months after incorporating, Harper, Stage, and Cox begin to think about expansion of service to Indiana, which would require at least \$1,000,000 in additional capital, possibly from out of state.

A. Federal Registration Exemptions

1. Section 3(a)(11) Intrastate Offering and Rule 147: Same comments as for III.A.1. above.
2. Regulation D: Because the amount needed exceeds the (current) \$500,000 cap of Rule 504, Rule 505 or 506 are the next most likely choices. Each has its own special limits: issuers of 505 offerings must be able to meet the "bad boy" provisions of that rule, while issuers of 506 offerings must consider investor sophistication in addition to accreditation. (Note that Kentucky's ULOE "bad boy" provisions would apply to both 505 and 506 offerings -- usually not an issue, but it is reckless to assume it is not.) In each case, sales will be limited to 35 or fewer non-accredited investors.
3. Regulation A: This is a limited registration process promulgated under Securities Act § 3(b). It is available to issuers who want to issue up to \$1.5 million in securities, and has disclosure requirements similar to Part I of Form S-18 (the standard for disclosure for Rules 505 and 506 when non-accredited investors are included), so it should be considered when the dollar amount fits and an extensive disclosure document is needed anyway. The main benefits are that: (1) resales by buyers can take

place without the Rule 144 waiting period, for as long as the registration is effective; and (2) unaudited financial statements may be used.

B. Kentucky Registration Exemptions

1. Coordination with Regulation D: Coordination with Rule 505 or 506 under Kentucky's ULOE provisions (808 KAR 10:210, promulgated under KRS 292.410(1)(q) and amended to conform with federal elimination of later filings) would be the simplest. As noted above, Kentucky's ULOE "bad boy" provisions would apply to both 505 and 506 offerings, and sales will be limited to 35 or fewer non-accredited investors (plus, of course, an unlimited number of accredited investors). Note that Kentucky has its own suitability standards for non-accredited investors, based on the investment's not exceeding 10% of an investor's net worth. See the outline on Blue Sky Exemptions.
2. Coordination with Regulation A: There is no direct analogue to Regulation A in Kentucky's scheme of securities regulation. The offer and sale of securities in Kentucky qualified under federal Regulation A would have to be either exempted under the "limited offering exemption" (KRS 292.410(1)(i) (Appendix L3-5) or registered by qualification under KRS 292.370 and 292.380 (Appendix L4).

V. Using Stock as a Performance Incentive

Fact Situation 5: Paralegals are bright. They can tell when a business is doing well. Not unlike associates, they sometimes get annoyed when their time is billed out at a big multiple of what they are paid by the hour. Harper, Stage, and Cox recognize, reluctantly, that to retain the best and most experienced paralegals, they may need to issue the staff some stock in Legal Eaglets, Inc. or options to purchase it -- but probably no more than \$500,000 worth per year.

A. Federal Registration Exemptions

1. Generally: This is an area fraught with complexity. Offerings to employees, as a group, are accorded no special stature in the availability of exemptions. Ralston Purina got itself a permanent home in securities law case books by making what it thought was a private offering to its employees. See *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953); see also a useful BNA Corporate Practice Portfolio by Lorne & Morgan, *Securities Law Considerations Affecting Employee Benefit Plans*, which contains a helpful outline of the various securities issues raised by different plans.
2. Section 3(a)(11) Intrastate Offering and Rule 147: Same comments as for III.A.1. above.

3. Regulation D: See discussion at III.A.2. If under \$500,000, Rule 504 would be available. Probably useful as long as Legal Eaglets, Inc. stays relatively small, but more cumbersome with more employees and over periods extending into years.
4. Section 4(2): May be available if number of employees sufficiently small and knowledge of business and its performance is sufficient. But see *Ralston Purina*.
5. Proposed "700" Series of Rules: In Release 33-6726 (July 30, 1987) (attached), the SEC repropoed Rules 701-703, which would provide a special exemption for employee benefit plans and employment contracts. Originally proposed in January 1987, the repropoed rules would provide a perfect exemption for Legal Eagles' situation. The exemption is structured to allow a company to issue up to \$5 million in securities per year to its employees without registration. Filing of a Form 701 (analogous to Form D but not a prerequisite for the exemption) would be required.
6. Registration. If no exemptions apply, registration under Form S-18 or Regulation A needs to be considered. Once Legal Eaglets, Inc. is a reporting company under the Securities Exchange Act (see 1934 Act § 12(g)(1) -- only after assets exceed \$1 million and the company has more than 500 shareholders does this become an issue), it could use a short Form S-8 for its benefit plan.

B. Kentucky Registration Exemptions

1. KRS 292.400(11) Exemption for Employees' Investment Plans. This exemption (see Appendix L3-2) is intended to cover the interest an employee has in a "stock purchase, savings, pension, profit-sharing, or similar benefit plan" if the issuer-employer gives 30 days' notice to the Director. It does not cover the actual issue of securities to employees. No particular filing form is stipulated in the statute or regulations.
2. Coordination with Regulation D: If the offer is in fact \$500,000 or less and the federal Rule 504 exemption is relied on, see comments in III.B.1. above for the Limited Offering Exemption. No serious problems if fewer than 50 offerees involved. If the dollar amount is greater than \$500,000, and Rule 505 or 506 is relied on, see comments in IV.B.1. above.
3. Plans to Coordinate with the "700 Series." In a phone conversation with the Director, she indicated that the Division has no current plans to coordinate with Rules 701-703 in the same way it has with Rules 505 and 506. Therefore, issuers should plan on complying with either the limited offering exemption or Rules 505 and 506.

Employee Benefit Plans and Compensation Contracts

File No. S7-28-87

SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933, Release No. 33-6726, 17 CFR Parts 230 and 239

July 30, 1987

AGENCY: Securities and Exchange Commission.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: The Commission is repropounding for comment a new Rule 701, new temporary Rules 702 and 703, and the new Form 701 which would, if adopted, provide an exemption from the registration requirements of the Securities Act of 1933 (the "Securities Act") for offers and sales of securities pursuant to certain employee benefit plans or written contracts with employees relating to compensation.

DATE: Comments must be received on or before September 15, 1987.

ADDRESSES: All communications on this matter should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Comments should refer to File No. S7-28-87 and will be available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W. Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Richard K. Wulff or John D. Reynolds, (202) 272-2644, Office of Small Business Policy, Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: On January 16, 1987, the Commission published for comment n1 a proposed new rule, designated Rule 701, to be promulgated pursuant to the exemptive authority provided by section 3(b) of the Securities Act, n2 which would exempt from the registration requirements of such Act offers and sales of securities made in accordance with the terms of compensatory employee benefit plans or compensation agreements by issuers that are not subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") n3 ("non-reporting companies or issuers"). The notice of proposed rulemaking also published for comment a proposed temporary Rule 702 which conditioned the availability of the exemptive rule upon the filing of a brief notification Form 701 with the Commission.

n1 Release No. 33-6683 (January 16, 1987) [52 FR 3015]. That release also proposed certain revisions to the Commission's Regulation D [17 CFR 230.501-506]. Those revisions will be the subject of a separate release in the future.

n2 15 U.S.C. 77a et seq.

n3 15 U.S.C. 78a et seq. Issuers submitting home country reports pursuant to Rule 12g3-2 [17 CFR 240.12g3-2] would be eligible.

Certain revisions to the initial proposals have been made. Because of the substantive nature of these revisions, the Commission has decided to republish revised proposals for public comment. n4 This release focuses principally on the revisions to the initial proposal.

n4 The Commission received 26 comment letters regarding the initial proposed Rules 701, 702 and Form 701. The comment letters and a summary of comments (File No. S7-28-87) are available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

I. The Revised Proposals

The essential concern addressed by this series of proposals remains the same -- many privately-held companies have found the costs of complying with the registration requirements of the Securities Act and the subsequent reporting obligations under section 15(d) of the Exchange Act so burdensome that employee incentive arrangements are not being provided by them. As a consequence, employees must forego potentially valuable means of compensation. The Commission historically has recognized that when transactions of this nature are primarily compensatory and incentive oriented, some accommodation should be made under the Securities Act.

A. Preliminary Notes

Four preliminary notes continue to preface proposed Rule 701. These notes are the same as those initially proposed. The first note indicates that the antifraud provisions of the federal securities laws may require that certain disclosure be provided to employees purchasing securities even though Rule 701 does not, and that the exemption in the rule only pertains to the registration requirements of the Securities Act. The second note acknowledges the applicability of state law to securities transactions including the ones governed by Rule 701 and reminds issuers to consider the provisions of such laws. The third note states that reliance on the rule does not constitute an election; any other available exemption may also be relied upon. The fourth note indicates that the Rule 701 exemption is only available to the issuer of the securities offered and sold and not to affiliates or other persons for resale.

Commenters on the initial proposal recommended that additional preliminary notes be added to indicate the limited scope of the rule which only encompasses compensatory transactions, and to explain the application of Rule 701 with regard to foreign offerings. In view of changes made to the proposals, it does not appear that any additional explanatory notes are needed.

B. Proposed Rule 701

The exemption to be provided by proposed Rule 701(a) would permit offers of securities by a non-reporting company pursuant to the terms of compensatory employee arrangements (either by virtue of an employee benefit plan or a written contract relating to compensation) between that issuer and its employees, directors, general partners, trustees (if the issuer is a business trust) and officers, or the employees, directors, general partners, trustees and officers of the issuer's parents or majority-owned subsidiaries. As originally proposed the rule would have provided an

aggregate lifetime exemption of \$5 million for offers and sales, with sales being limited to \$1 million in any 12-month period. The new proposal eliminates these provisions.

The Commission believes that the lifetime limitation unduly restricted the utility of the rule, particularly for larger non-public companies that may have a large number of employees. To accommodate the needs of these larger issuers, while assuring that the exemption does not provide a threshold that small issuers could use to raise substantial capital from employees, the revised rule defines the annual sales exemption as the lesser of \$5 million or 15% of the issuer's total assets measured at the end of its last fiscal year. The revised rule would continue to permit offers of \$5 million to be outstanding whatever the size of the issuer.

The Commission solicits comment on the appropriateness of the asset test and requests comments on whether the 15% ceiling should be higher or lower, as well as whether the test should be defined in terms of stockholders' equity or some other capital account.

The Commission is proposing no change in the provisions that make the exemption available to transactions within the description of the rule commenced prior to its adoption, as long as ultimate sales occur after the effective date of Rule 701. Similarly, offers made by a company before it becomes subject to the reporting requirements of the Exchange Act may be consummated afterwards in reliance upon the rule. Companies registered or required to be registered under the Investment Company Act of 1940 n5 would not be eligible to use Rule 701.

n5 15 U.S.C. 80a-1 et seq.

The revised rule would permit sales up to \$5 million (regardless of total assets) in any fiscal year in which the issuer had an effective registration statement or the public announcement of an agreement in principle to effect a business combination. Thus, if a business combination was announced in the first month of the fiscal year, the issuer would have 11 months to sell up to the \$5 million limit. On the other hand, if the announcement was made in the eleventh month, there would be only one month in which to sell up to the newly-created \$5 million ceiling. The revised rule specifically provides that if the agreement in principle is terminated in the same fiscal year as it is announced, the Rule 701 ceiling for sales reverts to 15% of total assets, although sales already made in reliance upon the increased ceiling would be deemed to be in compliance with the rule. In the previous proposal, the issuer would have had 90 days after certain specified events to sell up to the \$5 million ceiling. Since under the revised proposal the measuring period is a fiscal year rather than a 12-month period, the 90-day provision could result in the ceiling limit being \$5 million for each of two fiscal years and, therefore has been deleted. Comments are specifically requested, however, on whether the 90-day provision should be included. Comments on other ways to handle year-end announcements are also requested.

A number of commenters on the initial proposal noted that frequently, especially with stock option plans, exercises are accelerated because of the death or disability of an employee. The proposed rule provides that sales to a disabled participant, or to the beneficiaries or estate of a participant, as a result of termination of employment because of disabil-

ity or death of such participant, will not reduce the available ceiling for sales by an issuer whose ceiling would be less than \$5 million. In no event, however, may sales in any fiscal year exceed \$5 million.

The aggregation principles applicable to Rule 701 have been revised. The revised rule no longer requires a reduction in offers or sales as a result of offers or sales made in violation of Section 5. Given the compensatory nature of the transactions under Rule 701, it does not appear necessary to reduce the potential benefits available to employees because of an issuer's prior unrelated violations of the statute.

The revised rule defines the manner of calculating the aggregate offering price and specifically indicates that services rendered or to be rendered by an employee or other eligible participant are not a part of the calculation.

The definitions of the appropriate compensatory arrangements within the ambit of Rule 701 have been modified from those originally proposed. The rule incorporates the simpler definition provided in Rule 405, n6 instead of the one contained in Rule 16b-3. n7 As a result, Rule 701 does not dictate any formal requirements for the employee benefit plan, except that it be in writing. The revision also makes clear that interests which constitute separate securities in such plans n8 are also to be exempted. Securities issued pursuant to employment compensation agreements would come within the Rule 701 exemption, as originally proposed.

n6 17 CFR 230.405.

n7 17 CFR 240.16b-3.

n8 See Release Nos. 33-6281 (January 15, 1981) [46 FR 8446], 33-6188 (February 1, 1980) [45 FR 8960].

With regard to eligible participants, the rule provides that the compensatory arrangements specified must be between the issuer and its (or its parents' or its majority-owned subsidiaries') employees, directors, general partners, trustees (if a business trust) or officers. Unlike the initial proposal, eligible participants would include employees of any majority-owned subsidiary of the issuer, rather than wholly-owned subsidiaries.

No special accommodation is made under the proposed rule for consultants and independent agents. While a number of comments were offered in support of the proposal to include these persons within the scope of the rule, the Commission believes such a change could lead to an exemption broader than the compensatory employee benefit purpose intended. In defining employee benefit plans both for registration purposes and for exemption from section 16(b) of the Exchange Act n9 the Commission traditionally has limited the transactions to those involving employees. There does not appear to be a compelling reason to distinguish proposed Rule 701. n10 It is likely that other exemptions will be available for sales to consultants, i.e., one of the exemptions under Regulation D or the private offering exemption provided by section 4(2) of the Securities Act. n11 Nonetheless, comments are requested as to whether consultants should be included perhaps on a selective basis, such as limiting their participation to some percentage of the dollar amount of securities being offered

each year pursuant to employment compensation arrangements, or limiting the number of consultants that might participate each year.

n9 17 CFR 240.16b-3.

n10 Registration exemptions for benefit plans at the state level generally are limited to employees and do not extend to consultants. See Uniform Securities Act, section 401(b)(12). It is understood that on a case-by-case basis, some state regulators may permit the exemption to be available where a few consultants are participating in a particular benefit plan.

n11 The Division of Corporation Finance has taken the position in interpretive letters that offerings under employee plans need not be integrated with other offers by an issuer for which a valid exemption is available. E.g., Tallgrass Technologies Corporation (March 20, 1986), Pacific Physician Services, Inc. (July 22, 1985).

C. Proposed Temporary Rules 702 and 703

Proposed temporary Rule 702 requires the filing of Form 701, a brief notification form, with the Commission no later than 30 days following the first sale of the issuer's securities that brings aggregate sales in reliance upon Rule 701 over \$50,000. Thereafter, the form should be annually amended within 30 days following the close of the issuer's fiscal year. These features are the same as originally proposed. Failure to file within the periods stated would constitute a violation of Rule 702. Unlike the earlier proposal, however, revised Rule 702 does not establish the filings of Form 701 as a condition to the Rule 701 exemption.

The public comments were strongly opposed to conditioning the exemption on the filing of Form 701. A number of alternatives were suggested in lieu thereof in order to satisfy the Commission's need to monitor the usefulness of the exemption as well as to oversee possible misuse of the provision. Certain of these alternatives, such as a fine for late filing, were not within the Commission's authority. Other suggestions, such as to eliminate the filing of the form as a condition to the exemption and obtain the information when the company becomes public, were not responsive to the Commission's concern with monitoring the utility of the exemption and with oversight of the transactions to determine whether the exemption is being used for capital-raising rather than incentive purposes.

To provide a disincentive for noncompliance with the filing requirements of Form 702, the Commission is proposing new temporary Rule 703, which would disqualify an issuer from use of Rule 701 if it has been found to have violated Rule 702. The proposed Rule 703 is patterned on Rule 252. n12 As with Rule 252, the Commission will have the authority to waive such disqualification upon a showing of good cause by the issuer that the Rule 701 exemption should not be denied.

n12 17 CFR 230.252.

Given the substantial increase in the dollar amount available for exempted transactions, by virtue of the use of a 12-month definition of the scope of the issue, and the elimination of the filing condition to the exemp-

tion, the temporary period for Rule 702, and Rule 703 as well, has been extended from three to five years. At the end of five years, Form 701 would cease to be a required filing and the disqualification provision would lapse, unless the Commission takes further action to establish such provisions on a permanent basis or extends their lives as temporary requirements.

Several commenters suggested that Rule 702 provide that Form 701 would be deemed filed with the Commission on the date received by the Commission or on the mailing date, if mailed by registered or certified mail. Recognizing a filing date other than the date the form is actually received places a substantial burden on the Commission's mail processing and filing units. This burden does not appear to be justified if the filing of the Form is no longer a condition to the exemption.

D. Proposed Form 701

Form 701 as proposed, continues as a brief notification provision which identifies the issuer, the types of the plans and/or contracts pursuant to which securities are being offered and sold in reliance upon the Rule 701 exemption, and the amount of securities offered and the amount sold. The form also requests information about the issuer's total assets at the end of its last fiscal year and the various events which allow additional sales to be consummated in any particular fiscal year.

II. Summary of Initial Regulatory Flexibility Analysis

An initial Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603 regarding Rules 701, 702, 703 and Form 701 has been prepared. The analysis notes that the proposals are a result of public inquiry as well as the Commission's own experience. Except for Rule 702, the proposals impose no new reporting, record keeping or other compliance requirements and in fact may eliminate the need to provide certain information. Members of the public who wish to obtain a copy of the Initial Regulatory Flexibility Analysis should contact Eloise A. Green in the Office of Small Business Policy, Division of Corporation Finance, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

III. Cost-Benefit Analysis

No specific data was provided on the Commission's original request for costs and benefits of the proposals. While many of the commenters suggested that significant cost savings could result from the proposals with concomitant benefits to employees who are not presently being offered plans for their employer's securities because of the registration requirements of the Securities Act, more specific data would be helpful. The Commission believes the exemption will not have a negative impact upon the protection of these investors.

IV. Statutory Basis and Text of the Proposed Rules

The new rules and Form are being proposed pursuant to sections 3(b) and 19(a) of the Securities Act.

TEXT OF PROPOSALS

Accordingly, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 230 - GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for Part 230 continues to read, in part, as follows:

Authority: Sections 230.100 to 230.174 issued under Sec. 19, 48 Stat. 85 as amended; 15 U.S.C. 77s, * * *

2. By adding a new § 230.701 to read as follows:

§ 230.701 Exemption for offers and sales of securities pursuant to certain compensatory employee benefit plans and contracts relating to compensation.

PRELIMINARY NOTES

- (1) *Nothing in this rule is intended to be or should be construed as in any way relieving issuers or persons acting on behalf of issuers from providing disclosure to employees or other persons within the scope of the rule adequate to satisfy the antifraud provisions of the federal securities laws. The rule only provides an exemption from the registration requirements of the Securities Act of 1933 (the "Act") [15 U.S.C. 77a et seq.].*
 - (2) *Nothing in the rule obviates the need to comply with any applicable state law relating to the offer and sale of securities.*
 - (3) *Attempted compliance with the rule does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption.*
 - (4) *The rule is only available to the issuer of the securities and not to any affiliate of the issuer or to any other person for reselling the securities. The rule provides an exemption only for the transactions in which the securities are offered or sold by the issuer, not for the securities themselves.*
- (a) **Exemption.** Offers and sales of securities that satisfy the conditions of paragraph (b) of this § 230.701 by an issuer that is not subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. 78a et seq.] and is not an investment company registered or required to be registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.] shall be exempt from the provisions of section 5 of the Act by virtue of section 3(b) of the Act. Offers made prior to the adoption of this § 230.701 if in accordance with this section had it been in effect, or offers made pursuant to this § 230.701 prior to the issuer becoming subject to the reporting requirements of section 13 or 15(d) of the Exchange Act are within the purview of this rule and sales in relation to such offers may be consummated thereafter in reliance upon this provision.

(b) Conditions to be met.

- (1) An exemption under this § 230.701 applies only to offers and sales of
 - (i) an issuer's securities pursuant to a written employee benefit plan established by that issuer for the participation of its employees, directors, general partners, trustees (where the issuer is a business trust) or officers, or the employees, directors, general partners, trustees or officers of its parents or majority-owned subsidiaries, and interests in such employee benefit plans, or
 - (ii) an issuer's securities pursuant to a written contract relating to compensation involving such persons.
- (2) For purposes of § 230.701 and 702, an employee benefit plan means any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, pension or similar plan.
- (3) The aggregate offering price for the securities being offered hereunder shall not exceed \$5,000,000 in any one of the issuer's fiscal years, reduced by sales made pursuant to this § 230.701 during that fiscal year. No adjustment to the aggregate offering price in this section shall be made for other offerings made in reliance upon other rules or regulations adopted pursuant to section 3(b) of the Act. The aggregate offering price under other rules and regulations adopted pursuant to section 3(b) shall not be reduced by offerings made under this § 230.701.

Aggregate offering price means the sum of all cash, property, notes, cancellation of debt or other consideration to be received by the issuer for the issuance of the securities. Generally, the services rendered or to be rendered by the employee would not be a part of the consideration for purposes of this provision. Non-cash consideration should be valued in reference to bona fide sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard.

- (4) Sales of securities under this § 230.701 in each of an issuer's fiscal years shall not exceed the lesser of 15 per centum of the issuer's total assets measured at the end of its last fiscal year, or \$5,000,000; Provided, however, :
 - (i) The limitation on sales shall be \$5,000,000 for any issuer in any fiscal year in which either of the following events occur:
 - (A) the effectiveness of a registration statement under the Act; or
 - (B) the public announcement of an agreement in principle to effect a business combination involving the issuer, provided that, if the agreement is terminated at any time during the fiscal year in which it is announced, the

limitation on sales would thereafter be as provided in § 230.701 (b)(4) except that sales made in excess of that limit before the termination of the agreement would be considered to have been made in compliance with this § 230.701.

- (ii) Sales made to a participant or to the beneficiaries or estate of a participant upon termination of employment as a result of disability or death of such participant shall not reduce the level of permitted sales pursuant to this subsection in a fiscal year, provided that, in no event shall sales exceed \$5,000,000 in any fiscal year.

(c) Resale Limitations.

- (1) Securities acquired in a transaction pursuant to this § 230.701 shall have the status of securities acquired in a transaction under section 4(2) of the Act.
- (2) Resales of such securities must be in compliance with the registration requirements of the Act or an exemption therefrom.
- (3) In the event that the issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, the status as securities acquired in a transaction under section 4(2) of the Act shall lapse 90 days after the issuer becomes subject to such reporting requirements.

3. By adding a new temporary § 230.702(T) to read as follows:

§ 230.702(T) Notice of sales pursuant to an exemption under § 230.701.

- (a) The issuer shall file with the Commission five copies of a notice on Form 701 [17 CFR 239.701] not later than 30 days after the first sale of securities which brings the aggregate sales pursuant to employee benefit plans and/or contracts relating to compensation exempt from the registration requirements of the Act by § 230.701 above \$50,000 and thereafter annually within 30 days following the end of the issuer's fiscal year.
- (b) One copy of every notice on Form 701 shall be manually signed by a person duly authorized by the issuer.
- (c) New filings and annual amendments must contain all the information requested on Form 701. Corrected filings need only report the name of the issuer and plan and the information being corrected. A separate filing is not required for each plan or contract relating to compensation.
- (d) A notice on Form 701 is considered filed with the Commission under paragraph (a) of this § 230.702 on the date of its receipt at the Commission's principal offices in Washington, D.C.
- (e) This section shall be effective until [5 years from the effective date of the final rule].

4. By adding a new temporary § 230.703(T) to read as follows:

§ 230.703(T) Disqualifying provision relating to an exemption under § 230.701.

- (a) No exemption under § 230.701 shall be available for an issuer if such issuer, any of its predecessors or affiliates have been subject to any order, judgment, or decree of any court of competent jurisdiction temporarily, preliminarily or permanently enjoining such person for failure to comply with § 230.702.
- (b) Paragraph (a) of this section shall not apply if the Commission determines, upon a showing of good cause, that it is not necessary under the circumstances that the exemption be denied.
- (c) This section shall be effective until [5 years from the effective date of the final rule].

PART 239 - FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

5. The authority citation for Part 239 continues to read, in part, as follows:

Authority: The Securities Act of 1933, 15 U.S.C. 77a, et seq.

6. By adding § 239.701 (Form 701) to read as follows: § 239.701 Form 701, report of sales of securities pursuant to a compensatory employee benefit plan or contract relating to compensation.

This form shall be used for the report of sales of securities pursuant to a compensatory employee benefit plan or contract relating to compensation under Rule 701 (§ 230.701 of this chapter).

By the Commission.

[Form 701 does not appear in the Code of Federal Regulations]

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These appendices are provided through the efforts and generosity of
Garrison R. Cox, Ogden and Robertson, Louisville, Kentucky.

SECTION L

APPENDIX 1: SELECTED FEDERAL EXEMPTIONS FROM REGISTRATION

Securities Act of 1933 § 3. Exempted securities.

(a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

(1) [Grandfather Clause for Securities Issued before July 27, 1933.]

(2) [Government, Bank Securities; IDB's; Interests in Certain Employee Plans.] Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or

any certificate of deposit for any of the foregoing; or

any security issued or guaranteed by any bank; or

any security issued by or representing an interest in or a direct obligation of a Federal Reserve bank; or

any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian; or

any security which is an industrial development bond [as defined in IRC 103(c) (2), with some other restrictions]; or

any interest or participation in a single trust fund, or in a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation, or security is issued in connection with

(A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under [IRC § 401],

(B) an annuity plan which meets the requirements for the deduction of the employer's contributions under [IRC § 404(a) (2)], or

(C) a governmental plan as defined in [IRC § 414(d)]

which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to [them] the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than [their] exclusive benefit, other than any plan described in clause (A), (B), or (C) of this paragraph

(i) the contributions under which are held in a single trust fund or in a separate account maintained by an insurance company for a single employer and under which an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interests or participations in the trust or separate account itself) issued by the employer or any [affiliated] company

...

- (ii) which covers employees some or all of whom are employees within the meaning of [IRC § 401(c)(1)], or
- (iii) which is a plan funded by an annuity contract described in [IRC § 403(b)].

[Clauses giving SEC power to exempt other interests in employee plans and defining "bank" omitted.]

- (3) [Commercial Paper.] Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited [note: this exemption has been severely limited by the SEC in 1933 Act Release 4412, CCH ¶¶ 2045-2046 (Sept. 20, 1961) -- it is much narrower than "commercial paper" under the UCC];
- (4) [Nonprofit Charitable Securities.] Any security issued by a person organized and operated exclusively for religious, education, benevolent, fraternal, charitable, or reformatory purpose and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual;
- (5) [S&L's; Farmers' Cooperative Organizations.]
- (6) [Railroad Equipment Trusts.]
- (7) [Securities Issued by Bankruptcy Receiver.] Certificates issued by a receiver or by a trustee or debtor in possession in a case under title 11 of the United States Code, with the approval of the court;
- (8) [Insurance Policies.] Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance [authority] of any State or Territory of the United States or the District of Columbia;
- (9) [Exchanges with Existing Security Holders.] Except with respect to a security exchanged in a case under title 11 of the United States Code, any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange;
- (10) [Other Special Exchanges.]
- (11) [Intrastate Transactions.] Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory. [Note: This exemption, which is really a transaction exemption rather than a security exemption, is much narrower than it appears on its face. See Rule 147 below for "safe harbor" provisions.]

- (b) The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$5,000,000.

[Note: Rules 504 and 505 under Regulation D were promulgated under this subsection, while Rule 506 was promulgated under § 4(2). This becomes important in the context of "integration" of offerings. Regulation A, a "short-form registration," was also promulgated under this subsection.]

- (c) [Securities Issued by Small Business Investment Companies.]

Securities Act of 1933 § 4. Exempted transactions.

The provisions of [§ 5 — registration requirements] of this title shall not apply to —

- (1) [Nonissuer Transactions.] transactions by any person other than an issuer, underwriter, or dealer.
[Note: to avoid status as an "underwriter," one must comply with the safe harbor provisions of Rule 144 — not usually easy for security holders of closely held corporations.]
- (2) [Private Transactions.] transactions by an issuer not involving any public offering.
- (3) [Dealer Transactions in Registered Securities.]
- (4) [Brokers' Transactions.]
- (5) [Transactions in Financial Institutions' or HUD's Mortgage-Backed Securities.]
- (6) [Transactions under \$5 Million.] transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered in reliance on this paragraph does not exceed the amount allowed under section 3(b) of this title, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf, and if the issuer files such notice with the Commission as the Commission shall prescribe.

[Note: this section was added in 1980 but is almost never used, as Rules 505 and 506 work better.]



APPENDIX 2: FEDERAL RULE 147
"SAFE HARBOR" PROVISIONS FOR FEDERAL INTRASTATE EXEMPTION

"Part of an Issue," "Person Resident," and "Doing Business Within"
for Purposes of 1933 Act Section 3(a) (11)

PRELIMINARY NOTES

1. This rule shall not raise any presumption that the exemption provided by § 3(a)(11) of the Act is not available for transactions by an issuer which do not satisfy all of the provisions of the rule.
2. Nothing in this rule obviates the need for compliance with any state law relating to the offer and sale of the securities.
3. Section 5 of the Act requires that all securities offered by the use of the mails or by any means or instruments of transportation or communication in interstate commerce be registered with the Commission. Congress, however, provided certain exemptions in the Act from such registration provisions where there was no practical need for registration or where the benefits of registration were too remote. Among those exemptions is that provided by § 3(a)(11) of the Act for transactions in any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within . . . such State or Territory.

The legislative history of that section suggests that the exemption was intended to apply only to issues genuinely local in character, which in reality represent local financing by local industries, carried out through local investment. Rule 147 is intended to provide more objective standards upon which responsible local businessmen intending to raise capital from local sources may rely in claiming the § 3(a)(11) exemption.

All of the terms and conditions of the rule must be satisfied in order for the rule to be available. These are:

- (i) that the issuer be a resident of and doing business within the state or territory in which all offers and sales are made; and
- (ii) that no part of the issue be offered or sold to non-residents within the period of time specified in the rule.

For purposes of the rule the definition of "issuer" in § 2(4) of the Act shall apply.

All offers, offers to sell, offers for sale, and sales which are part of the same issue must meet all of the conditions of Rule 147 for the rule to be available. The determination whether offers, offers to sell, offers for sale and sales of securities are part of the same issue (i.e., are deemed to be "integrated") will continue to be a question of fact and will depend on the particular circumstances. See Securities Act of 1933 Release No. 4434 (December 6, 1961) (26 FR

9153). Securities Act Release No. 4434 indicated that in determining whether offers and sales should be regarded as part of the same issue and thus should be integrated any one or more of the following factors may be determinative:

- (i) [Whether] the offerings [are] part of a single plan of financing;
- (ii) [Whether] the offerings involve issuance of the same class of securities;
- (iii) [Whether] the offerings [are] made at or about the same time;
- (iv) [Whether] the same type of consideration [is] to be received; and
- (v) [Whether] the offerings [are] made for the same general purpose.

Subparagraph (b) (2) of the rule, however, is designed to provide certainty to the extent feasible by identifying certain types of offers and sales of securities which will be deemed not part of an issue, for purposes of the rule only.

Persons claiming the availability of the rule have the burden of proving that they have satisfied all of its provisions. However, the rule does not establish exclusive standards for complying with the Section 3(a)(11) exemption. The exemption would also be available if the issuer satisfied the standards set forth in relevant administrative and judicial interpretations at the time of the offering but the issuer would have the burden of proving the availability of the exemption. Rule 147 relates to transactions exempted from the registration requirements of Section 5 of the Act by § 3(a)(11). Neither the rule nor § 3(a)(11) provides an exemption from the registration requirements of § 12(g) of the Securities Exchange Act of 1934, the anti-fraud provisions of the federal securities laws, the civil liability provisions of § 12(2) of the Act or other provisions of the federal securities laws.

Finally, in view of the objectives of the rule and the purposes and policies underlying the Act, the rule shall not be available to any person with respect to any offering which, although in technical compliance with the rule, is part of a plan or scheme by such person to make interstate offers or sales of securities. In such cases registration pursuant to the Act is required.

4. The rule provides an exemption for offers and sales by the issuer only. It is not available for offers or sales of securities by other persons. Section 3(a)(11) of the Act has been interpreted to permit offers and sales by persons controlling the issuer, if the exemption provided by that section would have been available to the issuer at the time of the offering. See Securities Act Release No. 4434. Controlling persons who want to offer or sell securities pursuant to § 3(a)(11) may continue to do so in accordance with applicable judicial and administrative interpretations.

[THE RULE]

- (a) **Transactions Covered.** Offers, offers to sell, offers for sale and sales by an issuer of its securities made in accordance with all of the terms and conditions of this rule shall be deemed to be part of an issue offered and sold only to persons resident within a single state or territory where the issuer is a person resident and doing business within such state or territory, within the meaning of § 3(a)(11) of the Act.
- (b) **Part of an Issue.**
- (1) For purposes of this rule, all securities of the issuer which are part of an issue shall be offered, offered for sale or sold in accordance with all of the terms and conditions of this rule.
 - (2) For purposes of this rule only, an issue shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemption provided by § 3 or § 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule, provided that, there are during either of said six month periods no offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

NOTE [to subsection (b)]: In the event that securities of the same or similar class as those offered pursuant to the rule are offered, offered for sale or sold less than six months prior to or subsequent to any offer, offer for sale or sale pursuant to this rule, see Preliminary Note 3 hereof as to which offers, offers to sell, offers for sale, or sales are part of an issue.

- (c) **Nature of the Issuer.** The issuer of the securities shall at the time of any offers and the sales be a person resident and doing business within the state or territory in which all of the offers, offers to sell, offers for sale and sales are made.
- (1) The issuer shall be deemed to be a resident of the state or territory in which:
 - (i) It is incorporated or organized, if a corporation, limited partnership, trust or other form of business organization that is organized under state or territorial law;
 - (ii) Its principal office is located, if a general partnership or other form of business organization that is not organized under any state or territorial law;
 - (iii) His principal residence is located if an individual.
 - (2) [**Triple 80% Test**] The issuer shall be deemed to be doing business within a state or territory if:
 - (i) The issuer derived at least 80% of its gross revenues and those of its subsidiaries on a consolidated basis

- (A) For its most recent fiscal year, if the first offer of any part of the issue is made during the first six months of the issuer's current fiscal year; or
- (B) For the first six months of its current fiscal year or during the twelve month fiscal period ending with such six month period, if the first offer of any part of the issue is made during the last six months of the issuer's current fiscal year from the operation of a business or of real property located in or from the rendering of services within such state or territory;

provided, however, that this provision does not apply to any issuer which has not had gross revenues in excess of \$5,000 from the sale of products or services or other conduct of its business for its most recent twelve month fiscal period;

- (ii) The issuer had at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue, at least 80% of its assets and those of its subsidiaries on a consolidated basis located within such state or territory;
 - (iii) The issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to this rule in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory; and
 - (iv) The principal office of the issuer is located within such state or territory.
- (d) **Offerees and Purchasers: Person Resident.** Offers, offers to sell, offers for sale and sales of securities that are part of an issue shall be made only to persons resident within the state or territory of which the issuer is a resident. For purposes of determining the residence of offerees and purchasers:
- (1) A corporation, partnership, trust or other form of business organization shall be deemed to be a resident of a state or territory if, at the time of the offer and sale to it, it has its principal office within such state or territory.
 - (2) An individual shall be deemed to be a resident of a state or territory if such individual has, at the time of the offer and sale to him, his principal residence in the state or territory.
 - (3) A corporation, partnership, trust or other form of business organization which is organized for the specific purpose of acquiring part of an issue offered pursuant to this rule shall be deemed not to be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory.
- (e) **Limitation of Resales.** During the period in which securities that are part of an issue are being offered and sold by the issuer, and for a period of nine months from the date of the last sale by the issuer of such securities, all resales of any part of the issue, by any person, shall be made only to persons resident within such state or territory.

NOTES [to subsection (e)]:

1. In the case of convertible securities resales of either the convertible security, or if it is converted, the underlying security, could be made during the period described in paragraph (e) only to persons resident within such state or territory. For purposes of this rule a conversion in reliance on § 3(a)(9) of the Act does not begin a new period.
2. Dealers must satisfy the requirements of Rule 15c2-11 under the Securities Exchange Act of 1934 prior to publishing any quotation for a security, or submitting any quotation for publication, in any quotation medium.

(f) Precautions Against Interstate Offers and Sales.

- (1) The issuer shall, in connection with any securities sold by it pursuant to this rule:
 - (i) Place a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the Act and setting forth the limitations on resale contained in paragraph (e);
 - (ii) Issue stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities make a notation in the appropriate records of the issuer; and
 - (iii) Obtain a written representation from each purchaser as to his residence.
- (2) The issuer shall, in connection with the issuance of new certificates for any of the securities that are part of the same issue that are presented for transfer during the time period specified in paragraph (e), take the steps required by paragraphs (f)(1)(i) and (ii).
- (3) The issuer shall, in connection with any offers, offers to sell, offers or sale or sales by it pursuant to this rule, disclose, in writing, the limitations on resale contained in paragraph (e) and the provisions of paragraphs (f)(1)(i) and (ii) and paragraph (f)(2).

[As adopted in Release No. 33-5450, Jan. 7, 1974, 39 FR 2356.]



APPENDIX 3: KENTUCKY EXEMPTIONS FROM REGISTRATION [ANNOTATED]

Sec. 292.400. Exempt securities.

KRS 292.340 to 292.390 [Registration Requirements] shall not apply to any of the following:

- (1) [Domestic Government Securities.] Any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of the foregoing; or any certificate of deposit for any of the foregoing;
- (2) [Foreign Government Securities.] Any security issued or guaranteed by Canada, any Canadian province, any political subdivision of any such province, any agency or corporate or other instrumentality of one or more of the foregoing, or any other foreign government with which the United States currently maintains diplomatic relations, if the security is recognized as a valid obligation by the issuer or guarantor;
- (3) [Financial Institution Securities.] Any security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States, or any bank, savings institutions, or trust company organized and supervised under the laws of any state;
- (4) [Savings and Loan Association Securities.] Any security issued by and representing an interest in or a debt of, or guaranteed by, any federal savings and loan association, or any building and loan or similar association organized under the laws of any state and authorized to do business in this state;
- (5) [Rural Cooperative Securities.] Securities issued by corporations formed under KRS Chapter 279 [Rural Electric & Rural Telephone Cooperative Corporations];
- (6) [Credit Union or Consumer Loan Company Securities.] Any security
 - (a) Issued or guaranteed by any federal credit union or any credit union; or
 - (b) Any security issued by any industrial loan association or consumer loan company organized and supervised under the laws of this state if either
 1. Such issuer has a capital account of at least \$1,000,000; or
 2. The issuer first files a notice with the director along with a copy of the prospectus or offering circular intended for distribution to prospective investors, which shall contain such information as the director by rule requires, and the director does not by order disallow the exemption within the next 10 full business days. "Capital account" means, for the most recent fiscal year, the sum of the par or stated value of all classes of capital stock, the consolidated surplus, whether capital or earned, and any indebtedness which by its terms is subordinate to the exempt security;

- (7) [Public Service Company Securities.] Any security issued or guaranteed by any railroad, other common carrier, public utility, or holding company which is:
- (a) Subject to the jurisdiction of the interstate commerce commission;
 - (b) A registered holding company under the Public Utility Holding Company Act of 1935 or a subsidiary of such a company within the meaning of that act;
 - (c) Regulated in respect of its rates and charges by a governmental authority of the United States or any state or municipality; or
 - (d) Regulated in respect of the issuance or guarantee of the security by a governmental authority of the United States, any state, Canada, or any Canadian province;
- (8) [Exchange Listed Securities.] Any security listed or approved for listing upon notice of issuance on the New York Stock Exchange, the American Stock Exchange, the Midwest Stock Exchange, the Pacific Stock Exchange or any other stock exchange approved by the director; any other security of the same issuer which is of senior or substantially equal rank; any security called for by subscription rights or warrants so listed or approved; or any warrant or right to purchase or subscribe to any of the foregoing [see 808 KAR 10:220 for exemption for securities approved for listing on the National Association of Securities Dealers Automated Quotations--National Market System (NASDAQ/NMS)];
- (9) [Securities of Religious, Charitable, etc. Organizations.] Any security issued by any person organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes, or as a chamber of commerce or trade or professional association [see KRS 292.415, 808 KAR 10:170 Section 1 for instructions for claiming this exemption];
- (10) [Short-term Commercial Paper.] Any commercial paper which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which evidence an obligation to pay cash within nine months of the date of issuance, exclusive of days of grace, or any renewal of such paper which is likewise limited, or any guarantee of such paper or of any such renewal;
- (11) [Employees' Investment Plans.] Any investment contract issued in connection with an employe's stock purchase, savings, pension, profit-sharing, or similar benefit plan if the director is notified in writing thirty days before the inception of the plan . . . [grandfather clause for pre-1961 plans omitted];
- (12) [Agricultural Cooperative Securities.] Securities issued by corporations formed under or which have adopted the provisions of KRS 272.101 to 272.345 [Agricultural Cooperative Associations] and patronage dividends or refunds be they in the form of stock, book equities, letters of credit or letters of advice issued by any agricultural cooperative association which are the result of distributable earnings or savings [see KRS 292.415, 808 KAR 10:170 Section 2 for instructions for claiming this exemption];

- (13) [Small Issues Defined by Regulation.] Any class of securities added by the director, by rule and subject to such terms and conditions as the director prescribes, to the securities exempted by this section, if the director finds that enforcement of this chapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or limited character of the public offering, but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$200,000 [note: no regulations have been promulgated under this section of the statute];
- (14) [Seasoned Issuer Securities.] Any security which meets all of the following conditions:
- (a) If the issuer is not organized under the laws of the United States or a state, it has appointed a duly authorized agent in the United States for service of process and has set forth the name and address of such agent in its prospectus;
 - (b) A class of the issuer's securities is required to be and is registered under section 12 of the Securities Exchange Act of 1934, and has been so registered for the 3 years immediately preceding the offering date;
 - (c) Neither the issuer nor a significant subsidiary has had a material default during the last 7 years (or the issuer's existence if less than 7 years) in the payment of:
 1. Principal, interest, dividend, or sinking fund installment on preferred stock or indebtedness for borrowed money; or
 2. Rentals under leases with terms of 3 years or more;
 - (d) The issuer has had consolidated net income (before extraordinary items and the cumulative effect of accounting changes) of at least \$1 million in 4 of its last 5 fiscal years including its last fiscal year; and if the offering is of interest bearing securities, has had for its last fiscal year, such net income, but before deduction for income taxes and depreciation, of at least 1-1/2 times the issuer's annual interest expense, giving effect to the proposed offering and the intended use of the proceeds. "Last fiscal year" means the most recent year for which audited financial statements are available, provided that such statements cover a fiscal period ended not more than 15 months from the commencement of the offering;
 - (e) If the offering is of stock or shares, other than preferred stock or shares, such securities have voting rights and such rights include:
 1. The right to have at least as many votes per share; and
 2. The right to vote on at least as many general corporate decisions, as each of the issuer's outstanding classes of stock or shares, except as otherwise required by law;
 - (f) If the offering is of stock or shares, other than preferred stock or shares, such securities are owned beneficially or of record, on any date within 6 months prior to the commencement of the offering, by at least 1200 persons, and on such date there are at least 750,000 such shares outstanding with an aggregate market value, based on the average bid price for that day, of at least \$3,750,000. In connection with the determination of the number of persons who are beneficial

owners of the stock or shares of an issuer, the issuer or broker-dealer may rely in good faith for the purposes of this section upon written information furnished by the record owners.

[See KRS 292.415, 808 KAR 10:170 Section 3 for instructions for claiming this exemption.]

Sec. 292.410. Exempt transactions.

- (1) Except as expressly provided, KRS 292.330 to 292.390 [Registration Requirements] shall not apply to any of the following transactions:
 - (a) [Isolated Non-Issuer Transaction.] Any isolated non-issuer transaction, whether effected through a broker-dealer or not;
 - (b) [Distributions of Outstanding Securities.] Any non-issuer distribution of an outstanding security by a registered broker-dealer, if the security has a fixed maturity or a fixed interest or dividend provision and there has been no default during the current fiscal year or within the three preceding fiscal years, or during the existence of the issuer and any predecessors if less than 3 years, in the payment of principal, interest, or dividends on the security;
 - (c) [Non-Issuer Transactions with Broker-Dealers.] Any non-issuer transaction effected by or through a registered broker-dealer pursuant to an unsolicited order or offer to buy; but the director may by rule require that the customer acknowledge upon a specified form that the sale was unsolicited, and that a signed copy of each such form be preserved by the broker-dealer for a specified period;
 - (d) [Underwriting Transactions.] Any transaction between the issuer or other person on whose behalf the offering is made and an underwriter, or among underwriters;
 - (e) [Mortgage Bonds Sold As Unit.] Any transaction in a bond or other evidence of indebtedness secured by a real or chattel first mortgage or deed of trust, or by an agreement for the sale of real estate or chattels, if the entire mortgage, deed of trust, or agreement, together with all the bonds or other evidences of indebtedness secured thereby, is offered and sold as a unit;
 - (f) [Transactions by Fiduciaries.] Any transaction by an executor, administrator, sheriff, marshal, receiver, trustee in bankruptcy, guardian, or conservator;
 - (g) [Transactions by Pledges.] Any transaction executed by a bona fide pledgee without any purpose of evading this chapter;
 - (h) [Institutional Investor Transactions.] Any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity;

- (i) [Limited Offerings.] Any transaction pursuant to an offer directed by the offeror to not more than 25 persons (other than those designated in paragraph (h)) [note: the 25-offeree limit can be increased to 50 offerees on written request to the Division of Securities] in this state during any period of 12 consecutive months, whether or not the offeror or any of the offerees is then present in this state, if
1. The seller reasonably believes that all the buyers are purchasing for investment, and
 2. No commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this state (other than those designated in paragraph (h));
- but the director may by rule or order, as to any security or transaction, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the conditions in subparagraphs 1. and 2. of this paragraph with or without the substitution of a limitation on remuneration [see KRS 292.415, 808 KAR 10:190 Section 1 for instructions for claiming this exemption];
- (j) [Limited Preorganization Subscriptions.] Any offer or sale of a preorganization certificate or subscription, if
1. No commission or other remuneration is paid or given directly or indirectly for soliciting any prospective subscriber,
 2. The number of subscribers does not exceed 25, and
 3. No payment is made by any subscriber;
- (k) [Conversions & Exercises of Warrants.] Any transaction pursuant to an offer to existing security holders of the issuer, including persons who at the time of the transaction are holders of convertible securities, non-transferable warrants, or transferable warrants exercisable within not more than 90 days of their issuance, if no commission or other remuneration (other than a standby commission) is paid or given directly or indirectly for soliciting any security holder in this state [see KRS 292.415, 808 KAR 10:190 Section 2 for instructions for claiming this exemption];
- (l) [Offers after Registration Statement Filed.] Any offer (but not a sale) of a security for which registration statements have been filed under both this chapter and the Securities Act of 1933 if no stop order or refusal order is in effect and no public proceeding or examination looking toward such an order is pending under either act;
- (m) [Stock Dividends.] The issuance of any stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if nothing of value is given by stockholders for the distribution other than the surrender of a right to a cash dividend where the stockholder can elect to take a dividend in cash or stock;
- (n) [Reclassifications & Reorganizations.] Any transaction incident to a right of conversion or a statutory or judicially approved reclassification, recapitalization, reorganization, quasi reorganization, stock split, reverse stock split, merger, consolidation or sale of assets [note: in a July 7, 1982, no-action letter, the Division of

Securities approved the reliance on this exemption for a conversion of a partnership into a corporation];

(o) ["Outsider" Transactions in Registered Securities.] Any transaction by a person who does not control, and is not controlled by or under common control with, the issuer if

1. The transaction is at a price reasonably related to the current market price,
2. The security is registered under Section 12 of the Securities Exchange Act of 1934 and the issuer files reports pursuant to Section 13 of that act, and
3. Copies of such federal registration statements, reports, forms or exhibits as the director may by rule or order require are filed with the director;

(p) ["Insider" Transactions in Registered Securities.] Any transaction by a person who may control, or may be controlled by or under common control with, the issuer if

1. The transaction is at a price reasonably related to the current market price,
2. The security is registered under Section 12 of the Securities Exchange Act of 1934 and the issuer files reports pursuant to Section 13 of that act, and
3. Copies of such federal registration statements, forms, reports or exhibits as the director may by rule or order require are filed with the director, and
4. Such sales by any such person comply with such rules as the director may prescribe;

(q) [Other Transactions Approved by Regulation.] Any transaction for which the director by rule or order finds that registration is not necessary or appropriate in the public interest or for the protection of investors. [See 808 KAR 10:150 for exemptions for "small business organizations" and professional service corporations. See 808 KAR 10:210 for Kentucky's Uniform Limited Offering Exemption ("ULOE"), which coordinates with the federal Regulation D exemption (but only for offerings under Rules 505 and 506, not under Rule 504). See 808 KAR 10:240 for exemption for offer or sale of 100% of issuer's stock to one person.]

(2) The director may by order deny or revoke the exemption specified in KRS 292.400 (6) [Credit Union or Consumer Loan Company Securities], (9) [Securities of Religious, Charitable, etc. Organizations], (11) [Employees' Investment Plans], (12) [Agricultural Cooperative Securities] or (13) [Small Issues Defined by Regulation] or in this section [any transaction exemption] with respect to a specific security or transaction. No such order may be entered without appropriate prior notice to all interested parties, opportunity for hearing, and written findings of fact and conclusions of law, except that the director may by order summarily deny or revoke any of the specified exemptions pending final determination of any proceeding under this subsection. Upon entry of a summary order, the director shall promptly notify all interested parties that it has been

entered and of the reasons therefor and that within 15 days of the receipt of a written request the matter will be set down for hearing. If a hearing is requested and none is ordered by the director, the order will remain in effect until it is modified or vacated by the director. If a hearing is requested or ordered, the director, after notice of and opportunity for hearing to all interested persons, may modify or vacate the order to extend it until final determination. No order under this subsection may operate retroactively. No person may be considered to have violated this chapter by reason of any offer or sale effected after the entry of an order under this subsection if he sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known of the order. In any proceeding under this chapter, the burden of proving an exemption from a definition is upon the person claiming it.

Sec. 292.415. Claim of exemption — Filing fee — Effect of failure to file.

- (1) Before any security may be issued as an exempt security under subsections (9) [Securities of Religious, Charitable, etc. Organizations; see 808 KAR 10:170 Section 1], (12) [Agricultural Cooperative Securities; see 808 KAR 10:170 Section 2], (13) [Small Issues Defined by Regulation — no current regulations] or (14) [Seasoned Issuer Securities; see 808 KAR 10:170 Section 3] of KRS 292.400, or offered for sale or sold as an exempt transaction under KRS 292.410(1)(i) [Limited Offerings; see 808 KAR 10:190 Section 1] or (k) [Conversions & Exercises of Warrants; see 808 KAR 10:190 Section 2], a claim of exemption must first be filed with the director and the director by order shall not have determined that the exemption is unavailable within the next 10 full business days. A claim of exemption filed under this section shall be in such form and contain such information as the director by rule or order requires and each offering shall be effective for a maximum of 12 consecutive months unless the director by rule or order extends such period of time, not to exceed 5 years.
- (2) For every claim of exemption filed with the director there shall be paid to the director a filing fee of \$100, except that for a claim of exemption filed under subsection (9) of KRS 292.400 [Securities of Religious, Charitable, etc. Organizations] the filing fee is .1% of the maximum aggregate offering price at which the securities are to be offered in this state, but the fee shall in no case be less than \$100 or more than \$500. The director shall have authority to amend or rescind under this subsection such filing fees by rule or order if the director determines that such fee is excessive under the circumstances.
- (3) Any person who fails to comply with this section shall be liable for a fee in the amount of 5 times the initial filing fee and the director may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of an exemption, if he finds that the order is in the public interest and that any security has been or is about to be offered or sold in violation of this section. If the director finds it appropriate in the public interest or necessary for the protection of investors, the director may order any issuer in violation of this section to make an offer of rescission.
- (4) Failure by any person to file a claim of exemption under this section shall not give rise to a private right of action under KRS 292.330(1)

- (4) Failure by any person to file a claim of exemption under this section shall not give rise to a private right of action under KRS 292.330(1) [Registration of Broker-Dealers, Agents and Investment Advisers], 292.340 [Registration of Securities] or 292.480 [Civil Liabilities] which would not otherwise be available under the provisions of this chapter.
- (5) Any person who fails to file a claim of exemption under this section, unless he does so intentionally, shall not be subject to KRS 292.991 [Criminal Penalties].

Sec. 292.420. Burden of proving exemption.

- (1) [Burden of Proof.] In any proceeding under this chapter, the burden of proving an exemption or an exception from a definition is upon the person claiming it.
- (2) [Information Requests by Director.] The director may require any person, who is selling or offering for sale or who is about to sell or offer for sale or who has sold or offered for sale any security within this state, to file a statement of the claim of exemption, if any, upon which such person is relying, and if any time, in the opinion of the director, the information contained in such statement filed is misleading, incorrect, inadequate, or fails to establish the right of exemption, he may require such person, agent, or investment adviser to file such information as may in his opinion be necessary to establish the claimed exemption. The refusal to furnish information as required by order of the director pursuant to the provisions of this subsection, within a reasonable time to be fixed by the director, shall be proper ground for the entry of an order by the director suspending and/or cancelling the registration of the broker-dealer, agent or investment adviser.
- (3) [Requests for Rulings.] The director shall have authority at all times to consider and determine whether any proposed sale, transaction, issue or security is entitled to an exemption or an exception from the definition accorded by this chapter, provided, however, that the director in his discretion may decline to exercise such authority as to any proposed sale, transaction, issue, or security. Any interested party desiring the director to exercise such authority shall submit to the director a verified statement of all material facts relating to the proposed sale, transaction, issue or security, which verified statement shall be accompanied by a request for a ruling as to the particular exemption or exception from definition, together with a filing fee of \$100. After such notice to interested parties as the director shall deem proper and after a hearing, if any, the director may enter an order finding the proposed sale, transaction, issue or security entitled or not entitled to the exemption or the exception from definition as claimed. An order so entered, unless an appeal be taken therefrom in the manner prescribed in this chapter, shall be binding upon the director, provided that the proposed sale, transaction, issue or security when consummated or issued conforms in every relevant and material particular with the facts as set forth in the verified statement as submitted.

APPENDIX 4: KENTUCKY REGISTRATION REQUIREMENTS [ANNOTATED]

Sec. 292.370. Registration by qualification.

- (1) Any security may be registered by qualification.
- (2) [Registration Statement Information Requirements; Consent to Service of Process.] A registration statement under this section shall contain the following information and be accompanied by the following documents, in addition to payment of the registration fee prescribed in KRS 292.380 and, if required under KRS 292.430, a consent to service of process meeting the requirements of that section:
 - (a) [Issuer Information.] With respect to the issuer and any significant subsidiary:
 - its name, address, and form of organization;
 - the state or foreign jurisdiction and date of its organization;
 - the general character and location of its business;
 - a description of its physical properties and equipment; and
 - a statement of the general competitive conditions in the industry or business in which it is or will be engaged;
 - (b) [D&O Information.] With respect to every director and officer of the issuer, or person occupying a similar status or performing similar functions:
 - his name, address, and principal occupation for the past 5 years;
 - the amount of securities of the issuer held by him as of a specified date within 90 days of the filing of the registration statement;
 - the amount of the securities covered by the registration statement to which he has indicated his intention to subscribe; and
 - a description of any material interest in any material transaction with the issuer or any subsidiary effected within the past 3 years or proposed to be effected by him or any of his associates as defined in the rules promulgated under the Securities Exchange Act of 1934;
 - (c) [D&O Compensation.] With respect to persons covered in paragraph (b):
 - the remuneration paid to all such persons in the aggregate during the past 12 months, and estimated to be paid during the next 12 months, directly or indirectly, by the issuer (together with all predecessors, parents and subsidiaries); and
 - the amount paid and to be paid to each of those who received or are to receive more than \$15,000;
 - (d) [Major Shareholder Information.] With respect to any person not named in paragraph (b), owning of record, or beneficially, if known, 10% or more of the outstanding shares of any class of equity security of the issuer:
 - the information specified in paragraphs (b) and (c) other than his occupation;

(e) [Promoter Information.] With respect to every promoter, not named in paragraphs (b) and (d), if the issuer was organized within the past 3 years:

the information specified in paragraphs (b) and (c);

any amount paid to him by the issuer within that period or intended to be paid to him; and

the consideration for any such payment;

(f) [Issuer Capitalization.] The capitalization and long-term debt (on both a current and pro forma basis) of the issuer and any significant subsidiary, including a description of each security outstanding or being registered or otherwise offered, and a statement of the amount and kind of consideration (whether in the form of cash, physical assets, services, patents, good will, or anything else) for which the issuer or any subsidiary has issued any of its securities within the past 2 years or is obligated to issue any of its securities;

(g) [Description of Offering.]

The kind and amount of securities to be offered;

the amount to be offered in this state;

the proposed offering price or the method by which it is to be computed, and any variation therefrom at which any portion of the offering is to be made to any persons or class of persons, other than the underwriters, with a specification of such person or class;

the basis upon which the offering is to be made if otherwise than for cash;

the estimated aggregate underwriting and selling discounts or commissions and finders' fees (including separately, cash, securities, contracts, or anything else of value to accrue to the underwriters or finders in connection with the offering);

the estimated amounts of other selling expenses, including legal, engineering and accounting charges;

the name and address of every underwriter and every recipient of a finders' fee;

a copy of any underwriting or selling-group agreement pursuant to which the distribution is to be made, or the proposed form of any such agreement whose terms have not yet been determined; and

a description of the plan of distribution of any securities which are to be offered otherwise than through an underwriter;

(h) [Use of Proceeds.]

The estimated cash proceeds to be received by the issuer from the offering;

the purposes for which the proceeds are to be used by the issuer;

the amount to be used for each purpose;

the order or priority in which the proceeds will be used for the purposes stated;

the amounts of any funds to be raised from other sources to achieve the purposes stated, and the sources of any such funds; and,

if any part of the proceeds is to be used to acquire any property (including good will) otherwise than in the ordinary course of business:

the names and addresses of the vendors,

the purchase price,

the cost basis or book value of the assets in the hands of the vendors (if they are officers, directors, partners or controlling shareholders of the issuer),

the names of any persons who have received commissions in connection with the acquisition and the amounts of any such commissions, and

any other expenses in connection with the acquisition (including the cost of borrowing money to finance the acquisition);

- (i) [Option Plans.] A description of any stock options or other security options outstanding, or to be created in connection with the offering, together with the amount of any such options held or to be held by every person required to be named in paragraph (b), (c), (d), (e), (g) or (h) and by any person who holds or will hold 10% or more in the aggregate of any such options;
- (j) [Management Contracts; Pending Litigation.]
The dates of, parties to, and general effect, concisely stated, of every management, employment or other material contract made or to be made otherwise than in the ordinary course of business if it is to be performed in whole or in part at or after the filing of the registration statement or was made within the last 2 years, together with a copy of every such contract; and
a description of any pending litigation or proceeding to which the issuer or any of its significant subsidiaries is a party and which may materially affect its business or assets (including any such litigation or proceeding known to be contemplated by governmental authorities);
- (k) [Other States.] The states in which a registration statement or similar document in connection with the offering has been or is expected to be filed;
- (l) [Adverse Orders.] Any adverse order, judgment or decree previously entered in connection with the offering by any court or the securities and exchange commission;
- (m) [Copy of Prospectus.] A copy of any prospectus or circular intended as of the effective date to be used in connection with the offering;
- (n) [Specimen of Security; Documents Describing Rights of Security Holders.]
A specimen or copy of the security being registered;

a copy of the issuer's articles of incorporation and bylaws, as currently in effect; and

a copy of any indenture or other instrument covering the security to be registered;

(o) [Opinion of Counsel.] A signed or conformed copy of an opinion of counsel, as to the legality of the security being registered (with an English translation if it is in a foreign language), which shall state, in addition to such matters as the director may request, whether the security when sold will be legally issued, fully paid, and nonassessable, and, if a debt security, a binding obligation of the issuer, and whether or not the offering, as contemplated in the registration statement will comply with the requirements of any claimed exemption from the registration provisions of the Securities Act of 1933;

(p) [Financial Statements.]

A balance sheet of the issuer as of a date not more than 4 months prior to the date of filing of the registration statement;

a balance sheet certified by an independent public or certified public accountant as of the close of the last fiscal year;

statements of income, changes in stockholders equity and changes in financial position for each of the issuer's 3 fiscal years preceding the date of the most recent balance sheet filed and for the period, if any, between the close of the most recent of such fiscal years and date of the most recent balance sheet filed, or, if the issuer has been in existence for less than 3 years, such statements for the period preceding the date of the most recent balance sheet filed; and

if any part of the proceeds of the offering is to be applied to the purchase of any business, the same financial statements which would be required if that business were the registrant.

The statements of income, changes in stockholders equity and changes in financial position shall be certified for the latest fiscal year presented;

(q) [Professionals' Consents.] The written consent of an accountant, engineer, appraiser, or other person whose profession gives authority to a statement made by him, if the person is named as having prepared or certified a report or valuation (other than a public and official document or statement) which is used in connection with the registration statement;

(r) [Other.] Such additional information as the director requires by rule or order.

Sec. 292.380. General provisions regarding registration of securities.

- (1) [Prospectus Delivery Requirements.] Except as otherwise expressly provided in this chapter a registration statement under this chapter becomes effective when the director so orders. The director may require as a condition of registration under this chapter that a prospectus containing any designated part of the appropriate information specified in this chapter be sent or given to each person to whom an offer is made before or concurrently with:
 - (a) the first written offer made to him (otherwise than by means of a public advertisement) by or for the account of the issuer or any other person on whose behalf the offering is being made, or by any underwriter or broker-dealer who is offering part of an unsold allotment or subscription taken by him as a participant in the distribution,
 - (b) the confirmation of any sale made by or for the account of any such person,
 - (c) payment pursuant to any such sale, or
 - (d) delivery of the security pursuant to any such sale, whichever first occurs;but the director shall accept for use under any such requirement a current prospectus or offering circular regarding the same securities filed under the Securities Act of 1933 or regulations thereunder.
- (2) [Who May File; Incorporation by Reference; Exceptions.] A registration statement may be filed by the issuer, any other person on whose behalf the offering is to be made, or a registered broker-dealer. Any document filed under this chapter or a predecessor law within 5 years preceding the filing of a registration statement may be incorporated by reference in the registration statement to the extent that the document is currently accurate. The director may by rule or otherwise permit the omission of any item of information or document from any registration statement.
- (3) [Possible Escrow Requirements.] The director may require as a condition of registration by qualification or coordination that
 - (a) the proceeds from the sale of the registered security be impounded until the issuer receives a specified amount; or
 - (b) any security issued within the past three years, or to be issued, to a promoter for a consideration substantially different from the public offering price, or to any person for a consideration other than cash, be delivered in escrow. The director may by rule or order determine the conditions of any escrow or impounding required hereunder. The director shall not reject a depository solely because of location in another state. All securities delivered in escrow to the director or some other depository satisfactory to him . . . shall be released from escrow no later than 10 years after the date of delivery into escrow [reference to pre-1968 escrows omitted].
- (4) [Ongoing Registration.] The director may also require as a condition of registration by qualification that the issuer undertake to keep the securities registered under this chapter for a period of up to five years or

until the securities become exempt securities under KRS 292.410 [sic-- probably should be 292.400(14)], and that the issuer forward to its security holders audited annual financials during the period for which the shares are registered. The director may by rule or order impose other undertakings.

- (5) [Fees.] For the registration of securities by notification or coordination, or qualification, there shall be paid to the director an examination fee of \$125 and a registration fee of .06% [\$60 per \$100,000] of the aggregate offering price of the securities which are to be offered in this State, but the registration fee shall in no case be less than \$60 nor more than \$1,200 [maximum is based on \$2 million issue]. The examination fee and the registration fee shall be payable [to the Kentucky State Treasurer] in separate checks. When a registration statement is withdrawn before the effective date or a pre-effective stop order is entered under KRS 292.390, the director shall retain the examination fee. For a registration by notification for market-making purposes only the examination fee need be paid. [Fees for mutual funds omitted.]
- (6) [Who May Offer and Sell; Duration of Registration for Nonissuers.] When securities are registered by notification or by coordination or by qualification, they may be offered and sold by the issuer, any other person on whose behalf they are registered or by any registered broker-dealer. Every registration statement is effective for one year from its effective date, or any longer period during which the security is being offered or distributed in a nonexempted transaction by or for the account of the issuer or other person on whose behalf the offering is being made or by any underwriter or broker-dealer who is still offering part of an unsold allotment or subscription taken by him as a participant in the distribution, except during the time a stop order is in effect under KRS 292.390. All outstanding securities of the same class as a registered security are considered to be registered for the purpose of any nonissuer transaction
- (a) so long as the registration statement is effective and
 - (b) between the thirtieth day after the entry of any stop order suspending or revoking the effectiveness of the registration statement under KRS 292.390 (if the registration statement did not relate in whole or in part to a nonissuer distribution) and one year from its effective date if any securities of the same class are outstanding.

A registration statement may be withdrawn otherwise only in the discretion of the director.

- (7) [Periodic Filings.] The director may require the person who filed the registration statement to file reports, not more often than quarterly, to keep reasonably current the information contained in the registration statement and to disclose the progress of the offering. The director shall impose a fee of \$10 for each such report filed with him.

APPENDIX 5: KENTUCKY REGISTRATION EXEMPTION REGULATIONS [ANNOTATED]

Rule 808 KAR 10:150. Registration exemptions.

Section 1. Pursuant to KRS 292.410(1)(g) [Other Transactions Approved by Regulation], the director having found that registration under the Kentucky Securities Act is not necessary or appropriate in the public interest or for the protection of investors, securities issued under the following classes of transactions shall be exempt from KRS 292.340 to 292.390 [Registration Requirements] and no claims of exemption need be filed with the division. However, any persons receiving commissions or other remuneration in connection with sales made pursuant to these exemptions are not relieved of compliance with the registration requirements of KRS 292.330 [Registration of broker-dealers, agents, and investment advisers].

- (1) Small business organization. Where ten or fewer persons organize a corporation, joint venture, or similar business organization other than a limited partnership, provided that:
 - (a) There are no more than 25 offerees [note: this number can be increased to 50 on written request to the Division of Securities];
 - (b) The security acquired does not evidence an oil, gas or mineral interest;
 - (c) Each person purchases with investment intent [defined in 808 KAR 10:160 Section 1.(2)];
 - (d) Each purchaser is an organizer on the date the issuer is formed;
 - (e) Each purchaser has access to information concerning the issuer;
 - (f) In connection with the organization, no commission or other remuneration is paid or given directly or indirectly to any person for soliciting any prospective buyer in this state;
 - (g) No public advertising through newspapers, television, radio, handbills, or other such solicitation will be employed in effectuating the proposed transaction.

[Note: in a 1982 opinion letter, the Director of the Division of Securities offered the following guidance on who can be an "organizer":

To be an organizer one does not have to be an incorporator. Neither does one have to be the originator or among the first individuals to discuss the general idea. It is sufficient that one be a part of the group during the final planning stages of the organization with sufficient understanding of the plan (either alone or through an agent) to make meaningful input and to make the decision as to whether or not to participate in the final product.]

- (2) Professional service corporation. Any security issued by a professional service corporation organized under KRS Chapter 274 [Professional Service Corporations] or substantially similar legislation of another state, provided:
 - (a) The professional service corporation complies with the ownership and transfer restrictions set forth in KRS Chapter 274;
 - (b) The securities are sold to a professional person;

- (c) The seller must reasonably believe that each buyer is purchasing for investment; and
- (d) Each professional is provided access to information concerning the professional service corporation.

[Amended eff. 7-9-85.]

Rule 808 KAR 10:160. Definitions.

Section 1. Definitions. When used in KRS Chapter 292 and the rules and regulations promulgated thereunder unless the context otherwise requires:

- (1) "Current financial statement" means a balance sheet of the issuer as of a date within four months prior to the filing of the claim of exemption, a profit and loss statement for the three fiscal years preceding the date of the balance sheet and for any period between the close of the last fiscal year and the date of the balance sheet, or for the period of the issuer's and any predecessor's existence if less than three years, and, if any part of the proceeds of the offering is to be applied to the purchase of any business, the same financial statements that would be required if that business were the issuer. The profit and loss statement shall be audited by an independent, certified public accountant for the latest fiscal year presented.
- (2) "Investment intent" or "purchasing for investment" means that securities cannot be purchased with a view to, or for resale in connection with, any distribution. Securities purchased with investment intent cannot be disposed of unless the securities are registered under KRS Chapter 292 or an exemption from the registration requirements of such chapter is available. As a result, the purchaser of these securities must be prepared to bear the economic risk of the investment for an indefinite period of time and have no need of liquidity of the investment. Where securities are purchased under KRS Chapter 292 for investment, investment intent shall be presumed if the purchaser retains such securities for two years from the date of consummation of the sale. However, any disposition of the securities within two years of the date of purchase, in the absence of an unforeseeable change of circumstances, shall create a presumption that the person did not purchase the securities with investment intent.

[Definitions of "promotional company," "subsidiary," and "significant subsidiary" omitted.]

[Eff. 10-7-81.]

Rule 808 KAR 10:170. Exemption claims from securities registration -- form.

Section 1. The following provisions shall apply to matters relating to an exemption from registration pursuant to KRS 292.400(9) [Securities of Religious, Charitable, etc. Organizations].

- (1) The claim of exemption required to be filed pursuant to KRS 291.415(1) shall contain the following:
 - (a) The filing fee (payable to Kentucky State Treasurer);
 - (b) A declaration that the KRS 292.400(9) exemption will be relied upon;
 - (c) A sample copy of the security that will be issued;
 - (d) A copy of the Articles of Incorporation and By-laws of the issuer or the equivalent governing instruments;
 - (e) A prospectus, offering circular, or memorandum making full disclosure of material facts, including a discussion of all salient risk factors;
 - (f) A representation that the offerees and purchasers shall have access to information concerning the issuer;
 - (g) Copies of all advertising or other material to be distributed in connection with the offering;
 - (h) A copy of the subscription agreement or other similar agreement;
 - (i) A copy of any proposed agreement or proposed form of agreement with a securities broker-dealer or underwriter;
 - (j) A copy of the preliminary or definitive Trust Indenture and/or Trust Agreement, if any;
 - (k) An opinion of counsel attesting to the authority of the issuer to offer and sell the securities and stating that after the sale the securities will be valid, binding obligations of the issuer in accordance with the issuer's governing documents. A letter from an authorized officer or the governing body of the issuer may in certain circumstances be accepted in lieu of this opinion;
 - (l) A representation that any commissions or other remuneration to be paid in connection with the offer or sale of the securities will be paid only to persons licensed pursuant to KRS 292.330.
- (2) The director may require additional information, documentation and undertakings or waive any of the above requirements. The director may require that the name and address of each purchaser and date of each such purchase be submitted to complete the filing.
- (3) For a claim of exemption pursuant to KRS 292.400(9) for an offering of securities of a church or other religious institution, a proposed issuer should be in substantial compliance with the North American Securities Administrators Association's Guidelines for Offerings of Church Bonds relative to disclosure in offering circulars and financial condition (CCH BLUE SKY LAW REPORTS).

Section 2. The following provisions shall apply to matters relating to an exemption from registration pursuant to KRS 292.400(12) [Agricultural Cooperative Securities].

- (1) The claim of exemption required to be filed pursuant to KRS 292.415(1) shall contain the following:

- (a) The filing fee of \$100 (payable to Kentucky State Treasurer);
 - (b) A declaration that the KRS 292.400(12) exemption will be relied upon;
 - (c) A sample copy of the security that will be issued;
 - (d) A copy of the Articles of Incorporation and By-laws of the issuer or the equivalent governing instruments;
 - (e) A prospectus, offering circular, or memorandum making full disclosure of material facts, including a discussion of all salient risk factors;
 - (f) A representation that the offerees and purchasers shall have access to information concerning the issuer;
 - (g) Current financial statements of the issuer [see 808 KAR 10:160 Section 1.(1) for definition of "current financial statement"];
 - (h) A copy of the subscription agreement or other similar agreement;
 - (i) A statement as to how the proceeds of the issue will be used; and
 - (j) A representation that any commission or other remuneration to be paid in connection with the offer or sale of the securities will be paid only to persons licensed pursuant to KRS 292.330.
- (2) The director may require additional information and documentation or waive any of the above requirements. The director may require that the name and address of each purchaser and the date of each such purchase be submitted to complete the filing.

Section 3. The following provisions shall apply to matters relating to an exemption from registration pursuant to KRS 292.400(14) [Seasoned Issuer Securities].

- (1) The claim of exemption required to be filed pursuant to KRS 292.415(1) shall contain the following:
 - (a) The filing fee of \$100 (payable to Kentucky State Treasurer);
 - (b) A declaration that the KRS 292.400(14) exemption will be relied upon; and
 - (c) A declaration as to how the issuer satisfies each of the specific requirements of KRS 292.400(14), which declaration shall be signed by a principal officer of the issuer.
- (2) The director may require additional information, documentation or undertakings to be filed.
- (3) The exemption shall be available for a period of five years unless material changes regarding the issuer which relate to the statutory requirements if the exemption make the exemption unavailable. The \$100 filing fee shall be waived for the last four years of the exemption period.
- (4) The issuer will notify the director annually (approximately one year from the effective date of the exemption) that the conditions of the exemption are still being complied with and that the issuer is still relying upon and claiming the exemption.
- (5) If the exemption becomes unavailable at any time as a result of material changes affecting the issuer's statutory exemption, the issuer shall immediately notify the director.

[amended eff. 7-9-85.]

Rule 808 KAR 10:190. Securities registration exemptions for certain business transactions.

Section 1. The following provisions shall apply to matters relating to an exemption from registration pursuant to KRS 292.410(1)(i) [Limited Offerings].

(1) The claim of exemption required to be filed with the director under KRS 292.415(1), where an offeror claims an exemption under KRS 292.410(1)(i), shall include the following:

(a) The filing fee of \$100 (payable to Kentucky State Treasurer);

(b) A letter containing:

(1.) A declaration that the KRS 292.410(1)(i) exemption will be relied upon;

(2.) Representations that:

offers will be made to not more than 25 persons in this state during the period of 12 consecutive months from the effective date of the exemption;

no commission or other remuneration will be paid or given directly or indirectly for soliciting any prospective buyer in this state;

the seller believes that all the buyers in this state are purchasing for investment;

each buyer will sign an appropriate "investment intent letter," a copy of which shall be included in the claim of exemption, stating in part that the buyer is not taking with a view to distribution [see 808 KAR 10:160 Section 1.(2) for definition of "investment intent"];

securities to be issued will bear an appropriate restrictive legend, a copy of which shall be submitted with the claim of exemption;

the offerees and purchasers shall have access to information concerning the issuer;

no public advertising or solicitation will be employed in effecting the proposed transaction; and

(c) A copy of the Articles of Incorporation, By-laws, limited partnership agreement, or other organizational document which reflects the security holders' rights;

(d) A prospectus, offering circular, or memorandum making full disclosure of material facts, including a discussion of all salient risk factors;

(e) Current financial statements [see 808 KAR 10:160 Section 1.(1) for definition] of the issuer shall be filed with the director and contained in the disclosure document;

(f) If available, a sample copy of the security.

(2) The director may require additional information and undertakings or waive any of the above requirements. The director may require that the names and addresses of offerees, actual purchasers and the dates of such purchases be submitted to complete the claim of exemption.

Section 2. The following provisions shall apply to matters relating to an exemption from registration pursuant to KRS 292.410(1)(k) [Conversions & Exercises of Warrants].

- [1] (a) The filing fee of \$100 (payable to Kentucky State Treasurer);
 - (b) A letter containing:
 - (1) A declaration that the KRS 292.410(1)(k) exemption will be relied upon;
 - (2) A statement disclosing the circumstances under which the outstanding shares were originally placed with the existing security holders, which statement shall indicate whether the shares were issued pursuant to a registration statement or in reliance upon an exemption from registration;
 - (3) The names, addresses, and number of shares or rights held by existing security holders in this state unless such information is not readily available, in which event the director shall be so advised; and
 - (4) A representation as to whether or not a commission or other remuneration [(other than a standby commission)] is to be paid or to be given directly or indirectly for soliciting any security holder in this state.
 - (c) A prospectus, offering circular, or memorandum making full disclosure of material facts, including a discussion of all salient risk factors;
- (2) The director may require additional information and undertakings or waive any of the above requirements.

Rule 808 KAR 10:210. Registration exemptions - Federal Regulation D.

Section 1. Pursuant to KRS 292.410(1)(g), the director having found that registration is not necessary or appropriate in the public interest or for the protection of investors, the following transaction is determined to be exempt from the registration provisions of KRS 292.340 through KRS 292.390.

(1) [Coordination with Rule 505/506 Offerings.] Any offer or sale of securities offered or sold in compliance with Securities Act of 1933, Regulation D, Rules 230.501-230.503 and either 230.505 or 230.506 as made effective in Release No. 33-6389 and which satisfies the following further conditions and limitations:

(a) [Commissions to Registered Broker-Dealers Only.] Persons receiving commissions, finders fees, or other remuneration in connection with sales of securities in reliance on this regulation are not relieved of compliance with KRS 292.330.

(b) ["Bad Boy" Provisions.] No exemption under this rule shall be available for the securities of any issuer, if any of the parties and/or persons described in Securities Act of 1933, Regulation A, Rule 230.252, Sections (c), (d), (e) or (f):

1. Has filed a registration statement which is the subject of a currently effective stop order entered pursuant to any state's law within 5 years prior to the commencement of the offering.
2. Has been convicted within 5 years prior to commencement of the offering on any felony or misdemeanor in connection with the purchase or sale of any security or any felony involving fraud or deceit including but not limited to forgery, embezzlement, obtaining money under false pretenses, larceny or conspiracy to defraud.
3. Is currently subject to any state's administrative order or judgment entered by that state's securities administrator within 5 years prior to reliance on this exemption or is subject to any state's administrative order or judgment in which fraud or deceit was found and the order or judgment was entered within 5 years of the expected offer and sale of securities in reliance upon this exemption.
4. Is currently subject to any state's administrative order or judgment which prohibits the use of any exemption from registration in connection with the purchase or sale of securities.
5. Is subject to any order, judgment or decree of any court of competent jurisdiction temporarily or preliminarily restraining or enjoining, or is subject to any order, judgment or decree of any court of competent jurisdiction, entered within 5 years prior to the commencement of the offering permanently restraining or enjoining, such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing with any state.
6. The prohibitions of subparagraphs 1 through 3 and subparagraph 5 of this paragraph shall not apply if the person subject to the disqual-

ification is duly licensed or registered to conduct securities related business in the state in which the administrative order or judgment was entered against such person or if the broker/dealer employing such person is licensed or registered in this state and the Form BD filed with this state discloses the order, conviction, judgment or decree relating to such person.

7. Any disqualification caused by this section is automatically waived if the state which created the basis for disqualification determines upon a showing of good cause that it is not necessary under the circumstances that the exemption be denied.

(c) [Filing Requirement.] The issuer shall file with the Division of Securities a notice on Form D (17 CFR 239.550) no later than 15 days after the first sale of securities to an investor in this state which results from an offer being made in reliance upon this exemption.

1. Every notice on Form D shall be manually signed by a person duly authorized by the issuer.
2. Any information furnished by the issuer to offerees shall be filed with the notice required pursuant to subparagraph 1 of this paragraph and, if such information is altered in any way during the course of the offering, the Division of Securities shall be notified of such amendment within 15 days after an offer using such amended information.
3. There is no filing fee.
4. In the event that the issuer files any additional documents with the United States Securities and Exchange Commission subsequent to its initial filing, copies of same shall be filed with the Division of Securities.

(d) [Additional Suitability Requirements for Investors.] In all sales to non-accredited investors the issuer and any person acting on its behalf shall have reasonable grounds to believe and after making reasonable inquiry shall believe that both of the following conditions are satisfied:

1. The investment is suitable for the purchaser upon the basis of the facts, if any, disclosed by the purchaser as to his other security holdings and as to his financial situations and needs. For the limited purpose of this condition only, it may be presumed that if the investment does not exceed 10% of the investor's net worth, it is suitable.
2. The purchaser either alone or with his/her purchaser representative(s) has such knowledge and experience in financial and business matters that he/she is or they are capable of evaluating the merits and risk of the prospective investment.

- (2) Offers and sales which are exempt under this rule may not be combined with offers and sales exempt under any other rule or section of this Act; however, nothing in this limitation shall act as an election. Should for any

reason the offers and sales fail to comply with all of the conditions for this exemption, the issuer may claim the availability of any other applicable exemption.

- (3) [Anti-fraud Provisions Not Affected.] Nothing in this exemption is intended to or should be construed as in any way relieving issuers or persons acting on behalf of issuers from providing disclosure to prospective investors adequate to satisfy the anti-fraud provisions of this state's securities law.
- (4) In any proceeding involving this rule, the burden of proving the exemption or an exception from a definition or condition is upon the person claiming it.
- (5) In view of the objective of this rule and the purpose and policies underlying the securities act, the exemption is not available to any issuer with respect to any transaction which, although in technical compliance with this rule, is part of a plan or scheme to evade registration or the conditions or imitations explicitly stated in this rule.

[amended eff. 6-10-86.]



BASIC RESOURCES FOR PRACTICING SECURITIES LAW

Federal Securities Law

L. Loss, *Fundamentals of Securities Regulation* (2d edition 1987). A valuable one-volume resource from the dean of securities law.

Federal Securities Law Reporter (CCH). A seven-volume set essential for thorough research. CCH also puts out a smaller, cheaper, unannotated five-volume set, *Federal Securities Laws*.

LEXIS. On-line library from Mead Data. The FEDSEC library has files (sub-libraries) containing all federal statutes, regulations, releases, cases, and no-action letters. The best way to access the body of law found in no-action letters. WESTLAW has a similar library, but I have never used it, so cannot comment.

J. Hicks, *1987 Limited Offering Exemptions: Regulation D* (1987). Published by Clark Boardman Company, Ltd., this softbound book has 774 pages discussing Regulation D, including charts showing states' efforts to coordinate with it. Updated annually.

W. Prifti, *Securities: Public & Private Offerings* (rev. ed. 1986). A useful one-volume treatise, more accessible than Loss.

Free Aids from Financial Printers:

1. Bowne, *Rules & Regulations of the Securities & Exchange Commission*. A "little red box" of pamphlets, updated regularly, setting out the statutes, regulations, and forms needed for most securities work.
2. Chas. P. Young Company *Securities Regulation Handbook*. Two-volume set with monthly updates of new regulatory issues.
3. Donnelley *SEC Handbook*. A two-volume set with much the same material. Reissued annually.

State Securities Law ("Blue Sky" Law)

Blue Sky Law Reporter (CCH). The Bible for state securities law issues. Four volumes. All other blue sky resources refer back to this service. LEXIS now has this entire service on-line in its CCHSKY library.

J. Long, *Blue Sky Law* (1985, updated & expanded to 2 volumes 11/87). Volumes 12 and 12A of Clark Boardman's *Securities Law* series. For both novices and experienced securities lawyers.

R. Fein, *State Securities Law* (Chart, last revised 8/87). This 26" x 40" chart, annotated with 265 footnotes bound separately, condenses a lot of law into one place. Useful short cut for research in the CCH service. Published by the ABA, 750 North Lake Shore Drive, Chicago, IL 60611 \$12.50, Publication No. 507-0074.